

Tax Expenditure Analysis and  
Housing Policy Reform

by

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Submitted in partial fulfillment  
of the requirements of the  
degree of Master of City Planning

at the

Massachusetts Institute of Technology

June 1980

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May 1, 1980

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ABSTRACT

The thesis presents a critique of the tax expenditure concept. It first traces the history of tax expenditures housing programs, and then presents a history of the tax expenditure concept, showing its development in the context of tax reform.

In Section II, I argue that now that the tax expenditure concept is being utilized by budget reformers, it must be adapted to its new context. The drawbacks of using the tax-reform version of tax expenditure analysis in the new budget context are presented via a critique of the CBO study Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives. I argue that, if tax expenditure analysis is to be used as the basis for restructuring housing programs, it must break out of the narrow tax reform viewpoint and be melded with housing policy analysis. I present two alternative ways of melding tax expenditure analysis with analysis of low-income housing programs, as well as a new way of analyzing tax expenditures that benefit housing for the nonpoor.

The final section of the paper points out the limitations inherent in the tax expenditure concept. First, analysis of tax expenditures ignores the need to analyze programs involving other funding formats, namely credit programs and "uncontrollable" direct subsidy programs, to see if such programs meet budgetary goals of efficiency, visibility and accountability of expenditures. Second, a shift from a focus on tax expenditures exclusively to a focus on analysis of all forms of "backdoor financing" (e.g. tax expenditures, credit programs, and uncontrollable direct subsidies) makes it possible to place the persistence of backdoor methods of financing in historical perspective.

Thesis Supervisor: Langley Keyes

Title: Tax Expenditure Analysis and Housing Policy Reform

Introduction: the tax expenditure concept and housing  
policy analysis

When Stanley Surrey, then Assistant Secretary of the Treasury and now a professor at the Harvard Law School, introduced the concept of tax expenditures in 1967, his goal was to obtain a full accounting of federal expenditures as the basis for budget cuts. A full accounting, he pointed out, required an appraisal not only of direct subsidies but also of subsidies given in the form of tax forgiveness, subsidies he called "tax expenditures."<sup>1</sup> The history of this concept is the subject of Section I of this paper.

Surrey's message was taken up by tax reformers in the late 1960s. Their principal focus was on tax expenditures' undesirable impacts on the tax system: by excusing some people from paying taxes, they eroded the equity of the Internal Revenue Code. More recently, Surrey's "tax expenditure analysis" has been taken up by the Congressional budget reform movement that culminated in 1974 with passage of the Congressional Budget Act<sup>2</sup> and the establishment of the Congressional Budget Office. Budget reformers focus primarily on the failure of tax expenditure programs to meet budgetary goals, i.e. on tax expenditures' lack of visibility in the budget and on their cost inefficiency.

Both the tax-reform and the budget-reform versions of tax expenditure analysis contain much the same strategy for restructuring expenditure programs. The reformers agree

that many tax expenditures should simply be abolished, since many tax expenditures cannot be justified once they are viewed as expenditure programs. In the case of those tax expenditures that translate into justifiable expenditure programs, tax- and budget-reformers traditionally support a change in funding format, recommending that tax expenditures should be changed into direct subsidies.

The Congressional Budget Office's (CBO) Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives<sup>3</sup> uses this traditional approach. This study focuses on tax shelters, one set of tax expenditures that tax reformers found most objectionable, suggesting i) that those tax expenditures perhaps not justifiable as expenditure programs (tax shelters for nonresidential buildings and for other-than-low-income housing) should be abolished altogether; and ii) that those expenditures (i.e. tax shelters that benefit low-income housing) that clearly translate into justifiable expenditure programs should be changed in their funding format from tax expenditures to "direct subsidy alternatives."

The CBO study's traditional approach to tax expenditure analysis has severe drawbacks when presented as the basis for a proposed restructuring of housing programs. The first drawback stems from the constricted scope of the inquiry involved in traditional tax expenditure analysis as it developed in the context of tax reform. Tax expenditure analysis used for tax reform consists of identifying tax



expenditures one by one and then abolishing each or translating it into an alternative funding format (preferably a direct subsidy) that lacks the tax expenditure's deleterious impact on the tax system. When the tax-reform approach is used as the basis for restructuring housing programs, it severely constricts the scope of the inquiry that forms the basis of housing policy reform. The CBO study, for example, by concentrating on a translation of one set of tax expenditures (tax shelters) into direct subsidies, fails to inquire whether the lower-income housing strategy of which tax shelters are an integral part itself meets tax, budget and housing policy reform goals. By failing to question the desirability of the current housing strategy, the CBO study in effect endorses it, implying that the major political effort should be focused not on challenging the strategy in any major way, but rather on tinkering with the funding format of one of the many subsidies that comprise the strategy. Section II.A shows that this passive acceptance of the current lower-income housing strategy is unfortunate since the strategy has very severe limitations from the standpoint of tax, budget and housing policy goals, and argues that if tax expenditure analysis is to be used as the basis for restructuring housing expenditures, it must be integrated with housing policy analysis.<sup>4</sup>

Section II.B examines another drawback of traditional tax expenditure analysis that also stems from its original

use by tax reformers.<sup>5</sup> Tax reformers in attacking tax expenditures chose to focus on tax shelters, since they had the worst impact in terms of tax beneficiaries (i.e. their tax subsidies flowed almost exclusively to the rich). If tax expenditure analysis is to be used to restructure housing programs, however, reform priorities should not be determined exclusively by a given tax expenditure's impact on tax beneficiaries; its impact on housing beneficiaries should also be considered. For example, homeowner deductions, although they traditionally have been thought of as tax expenditures less regressive than tax shelters because of their impact on tax beneficiaries, are spectacularly regressive in their impact on housing beneficiaries. In fact, once homeowner deductions are taken into account, they so distort U.S. housing subsidies that approximately 80% of all federal housing subsidies go to the nonpoor.<sup>6</sup> Any attempt to use tax expenditure analysis as the basis for restructuring housing programs, therefore, must address the issue of homeowner deductions. The CBO study does not do so because it is part of a tax-reform battle that began with the Tax Reform Act of 1969,<sup>6a</sup> a battle in which the focus has been on tax shelters exclusively. But the Congress should re-examine the issue of homeowner deductions, particularly because recent changes in the tax law and in housing prices have robbed homeowner deductions of their traditional political invulnerability.

Section III of this paper somewhat changes the focus.<sup>7</sup> Whereas Sections I and II discuss how the tax expenditure concept has been used in the past and how it should be used in the future, Section III focuses on the limitations inherent in a "tax expenditure" approach. The chief drawback of tax expenditure analysis is that it defines tax expenditures as the objectionable funding format because tax expenditures lack visibility and are potentially cost inefficient and regressive. An analysis of all housing expenditures, however, shows that other funding formats share these drawbacks. Huge amounts of federal housing aid are given via credit-subsidy and credit-support programs that may involve substantial expenditures neither more visible nor less cost inefficient and regressive than are those housing programs formulated as tax expenditures. Even the direct subsidies to low-income housing are far from being the paradigm of budgetary frankness that tax expenditure analysts have painted them to be. They, too, traditionally have been designed so as to hide the long-term costs involved in constructing new units: the most recent "direct subsidy" program (Section 8) entails contracts committing the federal government for up to 40 years to costs impossible to quantify until that period has run. Section III ends with an analysis of why "backdoor" forms of financing<sup>8</sup> have been so pervasive in American domestic policy in general and in housing policy in particular. The section concludes that the claim of tax expenditure analysts

that tax expenditure programs are "inadvertent" is incorrect. Once tax expenditures are grouped with other forms of backdoor financing it becomes clear that resort to the back door persists because such financing resolves basic tensions inherent in the American approach to domestic programs, of which housing programs are but one example.

Section I: The history of the tax expenditure concept

This section begins with prehistory, in the form of a brief description of modern tax policy from its inception after World War II until the late 1960s, when Stanley Surrey introduced the concept of tax expenditures. The purpose of this discussion is to contest the contention of Surrey and his school that tax expenditures grew up inadvertently.<sup>9</sup> In fact, the basic tax expenditures for real estate are more accurately viewed as an integral part of the focus on economic growth and capital formation that dominated American tax policy from the end of World War II until the mid-1960s.<sup>10</sup> By the mid-1960s, American policymakers had decided that growth would continue virtually forever, so policies designed to foster capital formation no longer held unquestioned priority in tax policy. Attention focused away from capital formation and economic growth onto the issue of poverty.<sup>11</sup> Policies formulated in the earlier period were re-evaluated in terms of whether they helped those most in need. Inevitably, they were found lacking, since capital formation policies were by definition designed to benefit those with capital: businesses and the rich. Surrey's "tax expenditure" brand of tax reform should be viewed as an integral part of this process of re-evaluation from a poverty perspective of tax policies originally designed to spur capital formation.

The bulk of this section traces the introduction and

development of the "tax expenditure" concept. Its first major development was in the context of tax reform in the late 1960s, when the focus was on eliminating tax expenditures from the Internal Revenue Code in the interest of tax equity. Simultaneous to the first tax reform push, however, was a movement to make the tax code less regressive not by abolishing tax expenditures for the rich, but by enacting new tax expenditures for the poor. Tax expenditure analysis performed by housing experts traditionally has aligned itself with one or the other of these two major tax reform trends. Characteristically, housing experts who oppose existing housing programs for housing policy reasons independent of tax considerations have favored eliminating all tax expenditures. On the other hand, housing experts who support the low-income housing programs enacted since 1968 have recommended introduction of tax expenditure programs for the poor.

Section I ends with a brief exposition of the "tax expenditure" concept in the new Congressional budget-reform context, as an introduction to the critique of the CBO study in Section III.

#### A. Tax policy from 1946 - mid-1960s

When the United States emerged from World War II, the federal income tax rates were for the first time high enough

so that the tax was a major factor in economic life. Rates had been very low before World War I, when they were raised to between 6 and 77 percent. Once the war ended rates fell precipitously, a trend that was reversed during the Depression. During World War II, rates climbed to the highest level ever and the number of taxpayers increased tenfold. The fall in tax rates that had followed World War I was not repeated after World War II: tax rates decreased very little until 1964, when the present 14 to 70 percent scale was adopted.<sup>12</sup>

The rise of the modern American income tax converged with another important trend: Keynesian economics.<sup>13</sup> Lord Maynard Keynes' theory that a free enterprise economy could be controlled by conscious use of macroeconomic policy had been used to get the country out of the Depression. Quite naturally, it remained an important force after the war, especially since American leaders feared a renewed depression once the soldiers came home (post-war depressions having been the rule of the past).

This combination of factors created the first period of federal income tax policy. The period was dominated by a desire for economic growth;<sup>14</sup> tax policy was viewed as one of the tools the government could and should use to achieve that growth. Hence the focus of tax policy was on capital formation.<sup>15</sup>

It was in this context that real estate tax expenditures reached their peak. Two sets of tax benefits coalesced during this period. The first were tax benefits available to businessmen engaged in real estate development. These encouraged capital investment directly. The second, consisting of tax benefits to homeowners, assisted capital investment by in effect lowering the after-tax price of homes held for personal use, thereby increasing demand for housing.

The most important element of tax benefits for developers, accelerated depreciation, was invented in this period as a way of spurring capital formation.<sup>16</sup> Depreciation is the method businesses use to allocate the cost of capital goods among the years of use. For example, if a \$500 typewriter is expected to last five years, good business practice is to put aside money into a fund that will be available to buy a new typewriter after five years. Annual depreciation is equivalent to the amount that must be put aside in a given year. Depreciation is important for tax purposes because taxes are imposed only on net business income, i.e. on gross income minus business expense. Since depreciation is a business expense, it is tax deductible.

The simplest form of depreciation is straight-line depreciation, under which the business sets aside the same amount each year (\$100, in the case of the example) as tax-deductible depreciation. Accelerated depreciation, in contrast to straight-line, allows the business to deduct a higher



percentage of the total cost (and, therefore, to pay less taxes) in the early years. This is of economic value because it defers the moment when taxes are due, and so gives the businessman the use of his money for a longer period. Since presumably he will put that money to work, either by reinvesting himself or by lending it at interest, the result will be increased overall investment in the economy.

Before 1946, the Internal Revenue Service favored straight-line depreciation. In 1946, the Treasury authorized limited use of accelerated depreciation by administrative action. However, few taxpayers used accelerated depreciation until 1954, when the tax law was officially changed to allow for it.<sup>17</sup>

During this postwar period, a complex set of depreciation rules grew up giving expression to the capital formation goal. This was done by allowing different rates of acceleration for different types of buildings.<sup>18</sup> New buildings that added to total available capital were rewarded more than were existing buildings: 200% (i.e. double) declining balance and sum-of-the-years' digits depreciation were allowed for new construction, whereas only 150% declining balance was allowed for used buildings.<sup>19</sup> The focus on capital formation also meant that no distinction was made between housing, commercial and industrial development: the same accelerated rates were allowed for all buildings.

The other major<sup>20</sup> provision used with accelerated

depreciation was that allowing the interest and taxes incurred while a building was under construction to be deducted in full in the year they accrued, rather than being capitalized.<sup>21</sup> This gave a tax deferral benefit similar to that given by accelerated depreciation, since capitalization would have required that a flat percentage (of the total amount of construction period interest and taxes) be taken each year over the entire life of the building, whereas deduction allowed the full amount to be taken in the first year.<sup>22</sup>

Tax benefits for homeowners were granted in the form of personal, rather than business, deductions. As noted above, they induced capital investment indirectly, by raising the demand for homes (usually single-family) by about 20% above what it would have been in the absence of the tax benefits.<sup>23</sup> The most important deductions were those for annual property tax and for interest paid on mortgages. These deductions date back to the temporary income tax enacted during the Civil War.<sup>24</sup> In 1951, homeowners' were given another tax break that helped to ensure that they would feel free to "trade up" to bigger, newer houses. The "capital gains" deferral provision<sup>25</sup> provided that a homeowner who sold his house<sup>26</sup> did not need to pay taxes on the money he received for that sale to the extent that he invested the proceeds in another house.

Surrey and his followers make much of their claim that these tax benefits were "inadvertent."<sup>27</sup> They point

to the fact that homeowner deductions and the construction period interest provisions were not introduced with the intention of supporting real estate investment. Nor, they argue, was the accelerated depreciation designed for real estate: they point to the fact that in Congress the debate over accelerated depreciation focused not on buildings but on machinery and equipment.<sup>28</sup>

The passage of the capital gains provision illustrates that this is not the point. The capital gains provision was intended to reinforce accepted features of the tax code because they fit into the capital formation focus of contemporary tax policy. For the same reason, accelerated depreciation was made available for buildings and the construction period interest provision was preserved. (The fact that the debate around accelerated depreciation focused on machinery and equipment proves no more than that manufacturing was the primary focus of the provision, presumably because it constituted a much larger proportion of the American economy, than did building construction.) If Congress had wanted to eliminate accelerated depreciation for buildings, then or later, it could have done so. As for homeowner deductions and construction period interest, Congress could have eliminated them in 1954, when there was a complete overhaul of the tax code in which many obsolete provisions were eliminated. Instead, Congress chose to keep these provisions and combine them with new ones to achieve current

capital formation goals.

The fact that the tax code as the tax expenditure reformers found it (at least with regard to real estate) was based on a consistent theory of encouraging capital investment is important as background to tax reformers' later efforts to adopt tax expenditures to meet welfare goals.

B. The tax expenditure concept

1. Introduction of the concept

In 1967, President Johnson was at war with both Vietnam and poverty, and the country's economy was feeling the pinch. Johnson, however, who did not want to abandon either war, asked Congress to vote a 10% surcharge on all income taxes, and to let him decide where to cut spending. This Congress did, and so in late 1967 LBJ's Treasury Department was studying the Budget for areas in which spending could be reduced or eliminated.<sup>29</sup>

It was in this budgetary context that Stanley Surrey, the Assistant Secretary of the Treasury, introduced the concept of tax expenditures. He noted that the Treasury in its analysis of the Budget was overlooking an entire category of expenditures. While HEW's direct expenditures made through subsidy programs were studied line by line, another set of expenditures had been overlooked. These were "tax expenditures," money lost not when the Treasury spent money

it had collected, but when taxes were never collected. The money was not collected because the recipients were covered by tax loopholes or preferences that excused them from paying tax on income otherwise taxable.<sup>30</sup> Surrey stressed the need for a "full accounting" of these expenditures.<sup>31</sup>

To this budgetary reform message Surrey added an expenditure reform angle:

America faces many social problems that desperately require solution....Certainly, no one can quarrel with these social objectives....[However, t]he immediate leap to the tax solution serves only to stultify thinking about these social problems. Once the leap is made, there is no opportunity to explore the details of the problems. Yet a great many useful questions can be asked: For example, as to low-income housing in urban areas and jobs for the urban disadvantaged, just why has private enterprise not undertaken these tasks in the past? Is it that the immediate return is insufficient, or is it that the participation has been seen as only sporadic? What forms of private enterprise are best suited to the task?....More crucial, what measures are needed to induce the participation ...?

With these questions answered as best we can, the task is then imaginatively to search the arsenal of possible Governmental action -- if Governmental assistance is needed -- to see which forms of Governmental action can be most responsive, effective and efficient.<sup>32</sup>

## 2. Tax expenditure analysis transformed into a tax reform message

In 1969, the tax expenditure concept took on a third personality in the context of tax reform. As Surrey describes it, the step was a self-conscious one. After he left the Treasury, he was busy at work developing criteria that should

be used to choose between tax expenditures and direct subsidies.

This in turn led to the next step, that of linking tax reform to the concept of tax expenditures. Again, while in the Treasury, I had conducted the preparation of a major study on tax reform that was published early in 1969. This study essentially regarded the task of tax reform as that of restoring "fairness" to the federal tax system by ending both the escape of many well-to-do individuals and large corporations from the burdens of that system and the ironic contrast of placing an income tax on those still in the poverty class. This study, and the proposals it offered, became the basis for the Tax Reform Act of 1969. In reflecting on these developments I came to recognize that most of the matters considered in 1969...related to items in the Tax Expenditure Budget. This led to the view ...that the task of tax reform lay in a systematic exploration of [tax expenditures.]<sup>33</sup>

The school of tax reform that focused on "tax loopholes," as they were called before Surrey, began in the late 1950s, when Wilbur Mills became Chairman of the House Ways and Means Committee. In 1959, Mills tried to set the scene for a major attack on loopholes by holding a massive series of hearings that "covered virtually every type of income not subject to the full impact of the rate schedule" and "still is, more than a dozen years later, the most comprehensive discussion" of the subject.<sup>34</sup> This effort proved a nonstarter. But the movement to "close tax loopholes" gradually gained momentum, and burst out vividly into the political arena a decade later, when Secretary of the Treasury Joseph Barr delivered his famous speech in which he focused on the fact that many

wealthy taxpayers paid little or no tax and predicted a "taxpayers' revolt."<sup>35</sup> The fact that he did not state that the reason was that their income was covered by tax preferences simply added to the political uproar. The result was a tax reform movement, led by Treasury, that resulted in the most comprehensive overhaul of the tax code since 1954, in the Tax Reform Act (TRA) of 1969.<sup>36</sup>

This brief historical sketch illustrates that, from the beginning, the tax expenditure concept had implications for tax, budget, and expenditure reform. The fact that the concept affected so many areas merely shows how central and important an insight it is. However, although Surrey touched base with each of the three areas implicated, the development of the tax expenditure concept in each area had a different political and intellectual history. It is to these that we now turn.

### 3. The tax reform context

#### a. The tax reformers

The tax expenditure concept had its first great flowering in the arena of tax reform. There it converged with a movement for which (after gathering speed for a decade) the time had come.

The new "tax equity" focus introduced in the early 1960s created an important reorientation in tax policy. Tax provisions developed in the post-World War II capital

formation fervor were reassessed from the perspective of new concerns. Most programs that had looked desirable in the old light were found lacking in the new.

Prior to the sixties, tax preferences that benefitted those with capital had generally been considered desirable, on the assumption that tax savings would be treated as capital and so would be reinvested: the economy would grow and all would benefit. This was part of the central political thesis of the period, derived from Depression origins, best expressed by John Kennedy's speechwriters as "a rising tide raises all ships."

By the sixties, people had stopped focusing exclusively on the tide and had turned their attention to the height of the various ships. They found first that the wealthy had benefitted from the system's capital formation focus: returning capital to its owners through the tax system was, in the new perspective, giving tax breaks to businesses and to the rich.<sup>37</sup>

This change in perspective focused early on accelerated depreciation. In 1962 and 1963, the Treasury Department urged Congress to cut back on accelerated depreciation, and to eliminate it altogether for real estate (allowing only straight-line).<sup>38</sup> The current tax law allowed depreciation deductions in excess of actual economic depreciation in a given year. Once the unreflective willingness to give tax breaks said to encourage capital formation was gone,



accelerated depreciation allowances were unjustifiable.

The sharpest transition between the old mentality and the new was focused on the investment tax credit. Stanley Surrey himself was the principal architect of the credit in 1961.<sup>39</sup> The credit was daring and innovative in the post-World War II context, since it went beyond the utilization of concepts, such as depreciation, that were justifiable in terms of the internal logic of the tax code, to use a gimmick with no justification other than that it would help the U.S. catch up with Europe's rate of investment in industry.<sup>40</sup>

But, in the new context, the investment credit in its zeal to spur capital formation was reviled as a tax expenditure exactly because it completely broke away from the tax code.<sup>41</sup> Surrey had claimed from the beginning that he was not automatically opposed to all tax expenditures. Said Surrey in his initial speech:

This discussion is not to be taken as saying that all tax relief measures are bad -- or that all are good -- just as it is not intended to state that all Federal expenditures are bad or good. This is not a qualitative discussion of tax preferences or, as some say, tax loopholes.<sup>42</sup>

Particularly in the context of his original budget focus, all Surrey was asking was that tax as well as direct expenditures be recognized as expenditures, and that an informal choice be made between a tax and a subsidy approach.<sup>43</sup>

But while Surrey's claim persisted, its validity during the period of tax reform fervor is questionable. The sixties tax reformers, in Surrey's own words, were primarily concerned with "restoring fairness" to the tax system. "The prime objective of income tax reform," Surrey said in his influential Pathways to Tax Reform in 1973, "is to achieve greater fairness and thereby restore confidence of the public in that system...(a) confidence now seriously eroded."<sup>44</sup>

This focus on the tax beneficiaries of the tax expenditure programs led tax reformers to oppose virtually all tax expenditure programs, on grounds of purifying the tax code. All tax expenditures aimed at capital formation were opposed because their tax beneficiaries were those with capital: businesses and the rich. All tax expenditures that involved deductions were opposed because they gave higher benefits the wealthier the taxpayer.<sup>45</sup> Tax credits did not have this effect, but nevertheless they were useless to low-income taxpayers to the extent that the taxpayer owed less tax than the credit.<sup>46</sup>

Particularly in the area of real estate, where all the major tax expenditures were deductions<sup>47</sup> and all but the homeowner deductions were aimed directly at capital formation, Surrey and other tax reformers universally recommended translating extant tax expenditure programs into direct subsidy equivalents.<sup>48</sup> "As to rental housing, the task is to devise a direct subsidy for low-income housing."<sup>49</sup>

However, although tax reform goals clearly predominated in tax expenditure analysis during this period, budget goals were not completely forgotten. Although they clearly played second fiddle, they were consistently mentioned as reinforcing tax reform considerations. While the "prime objective" was to achieve tax fairness, the "second objective [was] to restore efficiency and economy in the expenditure of government funds...[Tax expenditure analysis] enables us to see that wasteful expenditure is the other side of the tax escape coin."<sup>50</sup> Thus, during this period, Surrey noted:

To sum up on the effects of the...real estate tax shelter...the system:  
--is costly and inefficient as a means of getting more housing and other construction;  
--offers no assurance that construction resources are directed to priority needs...;  
--is basically incompatible with the operation of a fair tax system and the important objectives of tax reform; and  
--is also incompatible with budgetary responsibility...<sup>51</sup>

Arguments one and four are budgetary; argument three is the tax reform argument.<sup>52</sup>

The Tax Reform Act (TRA) of 1969 was the tax reformers' first real show of political muscle. The real estate tax expenditures that had coalesced in the post-war period were one of their primary targets. Since it seemed politically unfeasible completely to eliminate them all in one fell swoop, the strategy adopted was to eliminate as many as possible, concentrating reform fervor on those provisions

least justifiable in terms of welfare concerns. The result was that the system of tax expenditures developed to spur capital formation was gradually adapted to reflect welfare concerns.

Two changes were made in the treatment of accelerated depreciation. The first was straightforward: the allowable acceleration rates were changed. The simple system of permitting double-declining balance (and sum-of-the-years'-digits) for new construction and 150% for existing buildings no longer made sense now that the capital formation rationale had lost its pre-eminence. In fact, once capital formation goals were submerged and accelerated depreciation was defined as an expenditure program, giving tax breaks to shopping centers and office buildings seemed unjustifiable as a governmental program. So the new accelerated depreciation rates favored housing. The old capital-formation distinction between existing buildings and new construction was preserved, perhaps partially because it had some tenuous rationale in terms of housing policy.<sup>53</sup> The TRA of 1969 allowed double declining balance and sum-of-the-years' digits only for new residential buildings,<sup>54</sup> 150% for new nonresidential,<sup>55</sup> 125% for used nonresidential,<sup>56</sup> and for used nonresidential, only straight-line depreciation.<sup>57</sup>

The second change in the accelerated depreciation provisions, having to do with so-called "recapture," is technically more complex. The "recapture" concept was an early

innovation of tax reformers. One of the primary objections to depreciation allowances is that they allow taxpayers to turn ordinary income into capital gain. To understand what this means, it is necessary to understand the basics of the real estate tax shelter. A simplified explanation follows. An investor in the 70% tax bracket receives an income flow of \$100,000 per year, which he wishes to shelter. So he invests \$100,000 in year 1 in a building worth \$1,000,000, buying it with a \$900,000 mortgage and his \$100,000 in cash. Tax law allows him to depreciate the entire cost of the building (\$1,000,000) in spite of the fact that he has paid out only \$100,000.<sup>58</sup> Thus the taxpayer can take straight-line depreciation of \$100,000/year for 10 years, and pay no taxes at all on the \$100,000 income flow for ten years. At the end of 10 years, he has saved \$700,000 in taxes.<sup>59</sup> But after 10 years, his tax benefits are used up, since no further depreciation deductions are allowed. So he will sell the building, say for \$1,000,000. The proceeds from that sale are income to him in year 10 and so will be taxed, but at the special lower rate the tax code allows for the sale of a capital asset (28% for a taxpayer who would pay a 70% tax on ordinary income).<sup>60</sup> So the taxpayer in year 10 pays only the 28% capital gains tax on his \$1,000,000 (i.e. \$280,000 in tax). If he had taken the \$1,000,000 as ordinary income at \$100,000 each year, instead of buying the building for tax shelter, he would have paid 70% per year, or \$700,000 over a 10-year period.

By using the tax shelter he has converted his \$1,000,000 in ordinary income into a \$1,000,000 capital gain, saving \$420,000 in tax in the process.<sup>61</sup>

To eliminate the ability of taxpayers to convert ordinary income into capital gain, the Treasury in 1963 proposed a recapture provision. The basic idea was that, if a taxpayer bought a building, took accelerated depreciation, and then quickly re-sold the building, the tax lost to the Treasury would be "recaptured." The specific proposal was that any owner who sold his building for a profit would have to pay tax at the ordinary income rate, rather than the capital gains rate, to the extent that his income from the building sale represented the recovery of depreciation previously deducted.<sup>62</sup> Under this proposal, part or all of a taxpayer's capital gain would be taxed as ordinary income unless the property had been held at least ten years at the time of sale.

Under the TRA of 1969, recapture was limited to that amount of depreciation in excess of straight-line.<sup>63</sup> However, escape from recapture was eliminated for all except residential buildings. In addition, the new law required that housing be held for 16 2/3 years (100 months) in order to avoid recapture. Thereafter, the amount subject to recapture decreased by 1% per month.

The example involving the investor with his \$1 million in income, because it provides a simple explanation of how a real estate tax shelter works, shows why tax reformers focused on the tax shelter. The investor in the example ultimately

"earns" \$400,000 (money he would have had to pay to the government but for the tax shelter) on a \$100,000 investment.<sup>64</sup> Tax reformers focused on tax shelters because they constituted a source of steep profits for investors at large costs to the Treasury.

Nonetheless, depreciation was by no means the largest tax expenditure benefiting housing. By one of Surrey's estimates, accelerated depreciation was costing the Treasury close to \$750 million per year,<sup>65</sup> at about the time when homeowner deductions were costing close to \$3 billion.<sup>66</sup> Treasury never pushed the issue of homeowner deductions, however, presumably because they seemed to have unbeatable support among the voters and because present subsidies are so large that abrupt removal would have serious economic consequences. As a recent Congressional study so delicately worded it in explaining why Treasury began its tradition of demurring on the issue in 1964:

When the tax code was revised in 1964 to specify types of nonbusiness expenses that could be deducted, treatment of property taxes and mortgage interest were retained because removing these deductions would have precipitated a large shift in overall tax burdens.<sup>67</sup>

b. The counterargument against the tax reformers

While Surrey led the tax reform movement, others began mobilizing his ideas to support the position exactly opposite to his own. This group accepted Surrey's insight that tax expenditures were expenditures.<sup>68</sup> They also agreed that existing tax expenditures (mostly enacted to encourage capital formation) tended to be egregiously regressive. But their solution was to enact tax expenditure programs for the poor to balance those available to the rich.

In the Tax Reform Act of 1969, the tax reformers' political strategy of concentrating their energies first on those tax loopholes least justifiable from a welfare perspective coincided with the strategy of this second group. Both groups' short-term strategy was to adapt extant capital formation tax expenditures to reflect welfare concerns. One result of the short-term strategy of both groups was the changes to the accelerated depreciation provisions (discussed above) in which housing was favored over other forms of real estate. But tax reformers' strategy diverged sharply from that of the second group on the issue of whether new tax expenditures should be enacted to benefit the poor.

Those who supported enactment of tax expenditures for the poor gave two reasons in support of their approach. One was that tax expenditures should be mobilized for the poor because it was not feasible politically to eliminate the tax expenditures for the rich. But the strongest argument regarding real estate tax shelters was that tax incentives should be used because they were particularly suited to effect the latest idea in low-income housing policy: letting private developers, rather than the government, build the housing.<sup>69</sup>

1968 was an important year for low-income housing policy. A variety of forces had converged to make it certain that the public housing program, the major low-income housing program since 1937, would be replaced.<sup>70</sup> 1968 was also an election



year in which Senator Robert Kennedy was running for president. The Senator chose to make part of his platform a proposal for a new low-income housing program based on new, more generous tax provisions to attract private developers into the business of providing low-income housing.<sup>71</sup> LBJ, presumably advised by Assistant Secretary Surrey, opposed the plan.

Although Robert Kennedy failed to get his proposed program enacted, the tax expenditure approach was recommended by President Johnson's Task Force on Housing (the Kaiser Commission)<sup>72</sup> and eventually was built into the 1968 Housing and Urban Development Act.<sup>73</sup> Title IX of the Act, which established the National Housing Partnerships (NHP), did not provide any additional tax benefits for low-income housing. Instead, it set up a legal structure designed to attract private money into low-income housing by utilizing pre-existing tax benefits, those in common use as part of the real estate tax shelter described above. NHP mobilized for low-income housing the process of syndication that had grown up spontaneously in the late 1960s. Syndication allowed a developer to profit by the real estate tax shelter as follows. A developer using the new Section 236 program established under the 1968 Housing Act could (incredibly enough) develop a \$1,000,000 building with only \$10,000 of his own capital.<sup>74</sup> However, many developers don't have enough income against which to set off all their depreciation deductions. Syndication creates a legal and financial structure that allows developers to

profit from these tax benefits by selling them to outside investors who do have the income they want to "shelter" by means of the deductions.<sup>75</sup> The investors profit just as did the investor in the first example; the developer's profits are the amount paid him by the investors in return for the shelter. Since the entire mortgage (not just the equity capital) can be depreciated, benefits are high enough to make the deal profitable for each party.

The tax reformers had won the first round in the sense that NHP used extant tax provisions; no new incentives were enacted. If tax reformers prevailed in the Housing Act, however, the second group was to win a major victory (of all places) in the TRA of 1969. The TRA contained three provisions designed to enhance the desirability of investment in low- and moderate-income housing. By far the most important of these, both from the point of view of the magnitude of the tax benefits offered and from the viewpoint of its tax reform opponents, was the controversial Section 167(k) provision, which allows for a five-year write-off of capital investment in substantially rehabilitated housing projects for low-income tenants.<sup>76</sup>

Section 167(k) is one of the new breed of tax expenditures, resembling Surrey's 1961 investment tax credit, in that it is a tax expenditure enacted with the clear understanding that its goals are social goals independent of the

basic revenue goal of the tax code. Section 167(k) is a trope on accelerated depreciation, in that it allows an eligible developer to deduct one-fifth of his development expenses each year for five years. It was clearly designed for syndication -- virtually no developer could use the massive deductions by himself. In the case of a \$1,000,000 building, the developer would have \$200,000 worth of deductions to sell for each of five years.

Although Section 167(k) was (and is) the most controversial, it was only one of three provisions in the 1969 TRA designed to benefit low- and moderate-income housing.<sup>77</sup> The first of the two others was the retention of pre-TRA depreciation rules for housing projects constructed before 1975 and financed by one of the programs designed to attract private developers into low- and moderate-income housing production.<sup>78</sup> These rules provided for recapture of depreciation in excess of straight-line on a declining basis only up to the tenth year, after which if the building was sold, there was no recapture at all.

The final provision benefiting low-income housing was similar to the capital gains provision for homeowners. It provided that an owner would not be taxed on the proceeds of the sale of qualifying low- or moderate-income housing to the extent that the proceeds of the sale were re-invested in similar qualifying housing.<sup>79</sup>

Surrey has provided a succinct version of the tax

reformers' answer to those who would solve the tax expenditure problem by adopting new tax expenditures to help the poor.

In insisting that a certain tax expenditure be abolished, he stated in Pathways:

If [other taxpayers] are still able to escape tax, the proper effort is to seek further refinement of remedies to reach those still escaping....But the argument "Don't stop to catch me since the other fellow is escaping" simply means that everyone continues to escape. Tax reform lies in not postponing efforts to block some escape until all the exits are sealed, but in systematically sealing off one exit after another. As this is done, attention is focused on the exits still open, the unfairness they present is more glaring, and, as a consequence, greater imagination, ingenuity and effort are brought to bear on those exits.<sup>80</sup>

c. Tax reform since 1969

Tax reform issues remain largely as they were defined in the late 1960s. Each side of the tax expenditure debate succeeded in enacting some of its provisions into the TRA of 1976.<sup>81</sup>

The tax reformers continued their assault on depreciation. Their principal victories were in the area of recapture. The 1976 Act eliminated the 1969 provisions exempting residential property from the new, stricter recapture rules, and made all residential properties except subsidized housing subject to full recapture.<sup>82</sup> In addition, the 1976 TRA cut back on the tax benefits incident to the treatment of construction-period interest and taxes, providing that only a portion of such interest and taxes may be deducted initially, with the balance amortized over periods of up to ten years.<sup>83</sup>

Tax benefits for low-income housing remained, but they were reduced. The holding period necessary to avoid recapture was increased substantially. Low-income housing was made subject to the rules that the TRA of 1969 applied to all residential real estate.<sup>84</sup> Low-income housing was made subject to the new rules concerning construction period interest beginning in 1982.<sup>85</sup> In addition, Section 167 (k), originally enacted in a five-year limitation, was extended until 1978.<sup>86</sup> (It has since been extended again.)<sup>87</sup> Certain technical problems were also cleared up that had arisen with regard to Section 167(k).<sup>88</sup>

However, the most spectacular recent reform effort was the Treasury's sudden move in early 1977 to eliminate all syndication, via an administrative ruling.<sup>89</sup> This move, which was rescinded before it ever was put into effect<sup>90</sup> is indicative of the strength of the pure tax reform message in certain bureaucratic domains.

Those who want to adapt tax expenditures to social goals also achieved a substantial victory in 1976, through the enactment of the historic preservation provisions, which provide a comprehensive set of tax incentives<sup>91</sup> for the rehabilitation of specified "certified historic structures," linked with tax disincentives for developers who tear down such properties.<sup>92</sup> The best-known provision, Section 191, is modeled on Section 167(k), and provides for a five-year write-off of expenses incurred for rehabilitation.

#### 4. The budget reform context

In the seventies the primary impetus for reform of tax expenditures has moved from tax to budget reformers.

Surrey noted in 1976

it is quite interesting to see that Congress -- or more accurately the Ways and Means Committee and a group of Senators -- is the only body really pushing [for reform of tax expenditures].<sup>93</sup> In the 1960s the Treasury was far ahead of the Congress. In the 1970s the Congress is far ahead of the Treasury.<sup>94</sup>

One major reason for the shift in the locus of power from tax to budget reformers is an institutional one. At a time when the Treasury, which had led the fight for tax reform during the Johnson years, had lost interest in pushing major tax reforms under the Nixon administration, the Congressional Budget Act of 1974 was setting up an alternative bureaucracy in the Democratic Congress. The Act created Committees of the Budget in both the House and the Senate, as well as a budget office that constituted a major staff operation.<sup>95</sup> In addition to creating the staffing and the power base for a renaissance of tax expenditure reform, the Act also gave to the Budget Committees a specific mandate to "devise methods of coordinating tax expenditures, policies and programs with direct budget outlays."<sup>96</sup>

As we have seen,<sup>97</sup> the tax expenditure concept originally was formulated as a way to highlight all expenditures, direct and indirect, in the process of making budget cuts. In this

initial budget context, Surrey was not opposed to tax expenditures per se. His focus was not on singling out tax expenditures or on changing them into direct subsidies, but on abolishing those that could not be justified as expenditures.

The tax expenditure concept changed in important ways as it moved from a budget- to a tax-reform context (which it did very soon after it was introduced). From a tax-reform perspective, tax expenditures were singled out because they eroded the equity of the Internal Revenue Code. The initial budgetary focus on abolishing unjustifiable tax expenditure programs was changed, since tax-reform goals could be achieved either by abolishing tax expenditures or by "translating" them into direct subsidies.

The tax expenditure concept changed again as it moved from a tax-reform context to the new budget-reform context. The two major shifts in focus are well illustrated in the CBO's Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives.

First, as the CBO study makes clear, the shift from tax- to budget-reform entails a shift in focus away from tax equity back to that classic budgetary concern, saving money. The first criterion used by the CBO study to evaluate alternative programs is cost,<sup>98</sup> followed closely by efficiency, which is also focused on cost: "[a] subsidy is efficient if it does what it is supposed to do at the lowest possible cost."<sup>99</sup> Tax equity, always first on tax reformers' minds,

now appears toward the end of the list,<sup>100</sup> followed by visibility and controllability,<sup>101</sup> another traditional budgetary concern.<sup>102</sup> In the context of tax reform, tax expenditure analysis had often used the budgetary concern for cost efficiency and visibility of expenditures to re-enforce tax equity goals;<sup>103</sup> but tax equity goals had clearly predominated. In the CBO study, by contrast, the budget-reform goals clearly come first.

The second major shift in focus illustrated by the CBO study is a subtle one. On one level, the study stays very close to the tax reformers' goal of either translating tax expenditures into direct subsidies or abolishing them completely. But while tax reformers focused most of their energies on attacking tax expenditures, the CBO study takes for granted that a tax expenditure format is undesirable and concentrates on the issue of how to translate the tax shelter into a non-tax expenditure program.<sup>104</sup>

The CBO study illustrates the kind of analysis that must back up a translation of the tax shelter into a direct subsidy. However, it becomes clear that the new budget-reform version of tax expenditure analysis involves a re-evaluation and restructuring of housing programs: in short, it involves housing policy reform. This potentiality was already apparent to Surry in Pathways:

[Tax expenditure analysis] means examining a program of financial assistance to a particular group to decide whether that assistance should



be given, in what amount, and on what terms. It really is not tax reform but "expenditure reform," and the issues and answers to be explored require different premises and different experts.<sup>105</sup>

Tax expenditure analysis in the new budget-reform context requires a rethinking of the entire expenditure pattern of which tax expenditures are a part. And, as Surrey also notes, those who most qualified to do this are neither tax nor budget experts but, in the case of real estate tax shelters, housing experts.

Unfortunately, housing analysts have not picked up this challenge. The three major published efforts by housing policy analysts to come to terms with the tax expenditure argument react only to the tax reform version of the tax expenditure argument. One adopts the tax reformers' view. The study of Federal Income Tax in Relation to Housing commissioned by President Johnson's Commission on Urban Problems in 1968

concedes at the outset a strong presumption against the use of the "backdoor" or tax route to public aid for this or similar causes. Readiness to mulct the tax structure for good purposes too often represents unwillingness to calculate the dollar costs, to escape habitual modes of thinking and examine creative alternatives, or to count the consequences to the vitality of the Nation's revenue system.<sup>106</sup>

Not surprisingly, the report recommends against the use of tax expenditures to solve the problem of slum housing. Another prominent analyst, Henry Aaron, also adopted the tax reformers'

viewpoint, but he focused on the need to abolish not real estate tax shelters (which benefit, among other things, housing for the poor), but homeowner deductions (most of the benefit of which goes to the nonpoor).<sup>107</sup> This represents a logical meshing of the tax and housing viewpoints, since homeowner deductions are bad policy from each perspective. The third major effort -- examples of which appear in the 1973 National Housing Policy Review<sup>108</sup> -- opposes the tax reformers' efforts to abolish tax expenditures by presenting an impressive series of studies designed to show that abolishing tax expenditures without substituting alternative policies would have a devastating effect on housing markets.<sup>109</sup>

Outside of these three studies, the tax expenditure argument has not been approached very analytically in housing circles. In most cases, the attitude of housing experts towards a given tax expenditure program has been determined by whether or not they support the policy approach of which the particular program is a part. Those who support the present production subsidy approach to low-income housing join HUD in defending existing tax subsidies as required by the political facts of life surrounding housing, whatever may be the tax or budgetary consequences of such programs.<sup>110</sup> Others, chiefly those who advocate housing allowances, join tax and budget reformers in decrying the shelters as wasteful and inefficient, and cite them as evidence of why low-income housing policy should abandon its present course.<sup>111</sup>

The CBO study illustrates why housing analysts cannot afford to use the tax expenditure argument merely as a debating point. The study is designed to be used as the basis for Congressional action on reform of housing programs. Yet its definition of the major issues in housing policy is seriously skewed from a housing policy standpoint. The study defines as the major low-income housing policy issue the question of what funding format the subsidy presently given as tax shelter should take. This approach focuses attention and political energy away from much more basic housing policy issues. As will be discussed in Section IIA, the tax shelter is only one of six types of federal subsidy involved in the roccoco structure of low-income housing finance today. A focus on changing the funding format of one of these six subsidies begs the question of whether the overall structure of low-income housing expenditures should be changed, either 1) by switching to a production subsidy that uses a more straightforward financing approach, or 2) by abandoning production subsidies altogether in favor of a "demand-side" housing allowance strategy.

By focusing political attention on tax shelters, the CBO study embodies an assumption that housing reform attention should be focused first on low-income housing programs. This implicit choice, made by Congress in the way it defined its mandate to the CBO, derives from the tax-reform tradition of defining the abolition of real estate tax shelters as a

major priority. Yet the choice to focus only on tax shelters -- expected to cost \$400 million<sup>112</sup> in FY 1981 -- without even considering the money (\$13.8 billion)<sup>113</sup> spent on another tax expenditure 60 times as large (homeowner deductions) involves a distortion of tax expenditure analysis. Until recently, the strategy of pressing hard on tax shelters while not pushing at all on homeowner deductions could be defended on the grounds that tax shelters were more regressive in terms of their tax beneficiaries, since homeowner deductions gave large tax benefits to the lower-middle class. But this is no longer the case: 95% of the tax benefits from homeowner deductions accrues to taxpayers with incomes over \$10,000. So the traditional tax-reform priority of concentrating on tax shelters because homeowner deductions are less regressive is no longer valid, since both measures are now seriously regressive. The focus therefore must shift from the tax to the housing beneficiaries of both measures. Once it does, reform of homeowner deductions becomes a central housing policy concern because of the huge amounts of money involved. Tax reformers traditionally have defended their focus on tax shelters by saying that a challenge to homeowner deductions would get nowhere in Congress. But now that homeowner deductions have become another instance of "socialism for the rich" this "political reality" may well have changed. In the light of new conditions, the old tax-reform strategy of concentrating political energy on tax shelters while

ignoring homeowner deductions seems merely a case of misplaced priorities, especially when presented as a definition of the major issues in reform of housing programs. This analysis of homeowner deductions is presented in Section II.B.

Section II: Critique of the CBO Study as a Tool for  
Restructuring Housing Programs

Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives performs the task it sets out for itself with thoroughness and rigor. The following critique focuses not on the CBO's execution, but on the way the CBO study defined (and had defined for it by the Congress) the task of mobilizing tax expenditure analysis to restructure lower-income housing programs.<sup>114</sup>

The CBO study embodies the traditional form of tax expenditure analysis developed in the context of tax- and budget-reform. This Section argues that traditional tax expenditure analysis has severe limitations when used as the basis for a restructuring of housing programs. If the goal is to restructure housing programs, tax expenditure analysis must be melded with housing policy analysis -- a melding that was not so necessary when tax expenditure analysis was presented merely as tax- and budget-reform. In the new context it is necessary to consider not only the tax beneficiaries and the budget impact of an isolated tax expenditure, but also to consider whether the tax expenditure is part of a general policy approach (i) that hinders achievement of tax- and budget-reform goals, and (ii) that constitutes bad housing policy in terms of its impact on housing beneficiaries.

A. The CBO Study's treatment of tax expenditures that benefit lower-income housing

The CBO's approach in Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives stays very close to the version of tax expenditure analysis developed in the context of tax reform. The study in fact grows out of a dispute that derives from tax reformers' strategy in the Tax Reform Acts of 1969 and 1976. In those acts, tax reformers made considerable headway toward their goal of abolishing real estate tax shelters. At the time of the 1976 Act, however, HUD expressed concern that abolishing all tax shelters would cripple production of lower-income housing.<sup>115</sup> Congress therefore abstained from abolishing tax shelters that benefit lower-income housing and commissioned the CBO study to examine programs that could substitute for tax shelters in the future.<sup>116</sup>

The study also adopts the tax reformers' approach of considering tax expenditures out of the housing context in which they occur. The study focuses on one set of tax expenditures -- the tax shelter -- and examines whether it can be translated into a "direct subsidy alternative." While the study formulates its tack as examining only direct subsidy alternatives, in fact it evaluates a number of alternatives that do not involve direct subsidies (tax credits and interest subsidies). The fact that it formulates its task as examining only direct subsidy alternatives again shows a tax reform perspective. Moreover, the study comes to a good tax

reform conclusion, rating as the most favorable alternative<sup>117</sup> a direct subsidy from HUD to developers. The grant would provide a substitute for the syndication benefits derived from the tax shelter, since syndication proceeds now are used to provide the developer with an up-front fee for his services.

Translating the real estate tax shelter benefiting low-income housing into a direct grant would improve the shelter from the standpoint of traditional tax-reform goals.<sup>118</sup> First, the translation would improve tax equity, since the grant would eliminate the regressive tax benefits on which the tax shelter is based. The translation would also improve the shelter from the standpoint of the budgetary concerns traditionally linked with "tax expenditure" tax reform: visibility of expenditures and cost efficiency. The expenditure involved in a direct grant to builders undoubtedly would be easier to identify and calculate than the expenditure involved in the present tax shelter approach. Moreover, two forms of cost-inefficiency inherent in the tax shelter would be eliminated. A direct grant would eliminate the inefficiency inherent in a syndication approach, which, by giving the builder his profit via syndication, creates a structure involving two sets of middlemen -- the investors and the syndicator. So for each dollar that goes to the builder, the Treasury must pay a higher sum -- the difference being the investors' and syndicators' profits. A second source of cost-inefficiency derives from the fact that current tax



shelters involve deductions. Syndicators (to ensure that all the shelter is sold) normally must price the shelter so it appeals to taxpayers in the 50% tax bracket. But many taxpayers buying shelter are in tax brackets higher than 50%, and consequently receive extra shelter at no increase in price. Their windfall means that although the Treasury pays them more in the form of tax savings for their participation, it receives from them no more in the form of construction incentive than from a 50% taxpayer. This inefficiency is impossible to avoid in a shelter based on depreciation deductions.

The CBO study does not present its proposed reform of the tax shelter as a tax reform proposal, however: rather, the reform is presented as a proposed restructuring of low-income housing subsidies. When examined in this light, the CBO study has serious limitations.

When the basic goal is tax reform, a narrow focus on the funding format of an isolated set of tax expenditures is justifiable. But this narrow focus is not suitable when the goal is to restructure housing programs. For this a broader perspective is required: tax shelters must be viewed as an integral part of an overall expenditure strategy. A focus on changing the funding format of one of the subsidies involved (e.g. tax shelters) means that more basic programs inherent in the strategy are ignored. These basic issues must be considered if housing programs are to be restructured

to answer tax- and budget-reform concerns.

This Section (in II.A.1) fills in the context<sup>119</sup> in which tax shelters are used by describing the financial structure of typical lower-income housing projects. This context shows the inadequacy of a restructuring of housing expenditures that limits itself to translating the tax shelter into a direct subsidy by showing that tax shelters are part of an extraordinarily complex system involving up to six subsidies, up to three of which involve additional tax expenditures. The Section (in II.A.2) addresses this inadequacy. It shows that merely "translating" one of these six subsidies from a tax expenditure into a direct subsidy does not fully address tax- and budget-reform concerns because the overall strategy of which tax shelters are but one part still would violate basic tax- and budget-reform goals. Tax-reform goals would continue to be violated in that other important tax expenditures still would be utilized. Budget-reform goals would be violated because, even if tax shelters were changed into direct grants, the subsidies involved still would be so complex that the strategy as a whole would be cost-inefficient, while the subsidies that comprise it still would lack visibility.

The Section then goes on to discuss the major inadequacy that results from the CBO study's divorce of tax shelters from their housing policy context, which concerns not tax-

or budget- but housing policy reform. By focusing exclusively on translating tax shelters, the CBO study defines as the major issue in restructuring lower-income housing programs the need to change the funding format of a single type of housing subsidy. Thus political attention is focused away from any attempt to evaluate the lower-income housing strategy as housing policy. Indeed, the desirability of the current housing strategy seems to be taken for granted. In effect, the CBO study uses tax expenditure analysis to justify the status quo. Since the study was commissioned by Congress to be used in imminent legislative reform, the choice of tax- and budget-reformers to support the status quo could have substantial impact on the future of lower-income housing policy.

The potential impact of the CBO study on housing policy reform shows why housing experts can no longer afford to use tax expenditure analysis merely as a debating point. Moreover, tax- and budget-reformers must recognize that if they propose to restructure housing (or other expenditure programs) to meet their tax and budget goals, they must meld their tax expenditure analysis with housing policy analysis, rather than making housing policy choices that are either hidden or inadvertant.

This section ends (II.A.3) with a sketch of how tax expenditure analysis, instead of being used to support the

status quo, could be used to support the need for change in housing policy. Two alternative ways of restructuring housing policy are examined that would improve housing programs from the standpoint of tax-, budget- and housing policy goals.

1. The context in which tax shelters are used: the six types of subsidy available for a typical lower-income housing project

The six types of subsidy to lower-income<sup>120</sup> housing reflect the complexity of the financial structure of multi-family housing projects (see Figure 1.). The first subsidy is a direct one,<sup>121</sup> Section 8.<sup>122</sup> Section 8 appropriations are voted each year, and are allocated by region according to HUD standards. Section 8 funds are made available to private developers, state housing finance agencies, and others in the form of Section 8 commitments. To get a Section 8 commitment, a developer must present a proposed low-income project. If the project is funded, its developers receive a commitment by HUD to pay for up to 40 years the difference between the rent that an eligible (i.e. low-income) tenant is required to pay (around 25% of his income) and the market rental of the tenant's apartment.

Once a developer has a Section 8 commitment, he will begin to assemble debt financing. This can be done in either of two ways: through conventional mortgage financing or through so-called "11(b) bonding."<sup>123</sup>

Figure 1: the six subsidies involved in a typical Section 8 project

CONVENTIONAL MORTGAGE OPTION

- #1. Section 8 (Section 202 funds may be combined with Section 8)  
direct subsidy(ies)
- #2. Construction loan: may involve federal subsidy if provided by SHFA.  
tax expenditure

Permanent loan:

- #3. FHA guarantee:  
credit subsidy
- #4(a) GNMA interest subsidy:  
direct subsidy

OR

- #4(b) SHFA interest subsidy:  
tax expenditure
- #5 Tax shelter:  
tax expenditures

SECTION 11(b) BONDING

- #1. Section 8 (Section 202)  
direct subsidy(ies)
- #2. Construction loan:  
GNMA guarantees of mortgage-backed bonds: credit subsidy
- #3. Tax exemption given to bank on the construction loan:  
tax expenditure.

Permanent loan:

- #4. Section 11(b) bonds are tax-exempt municipal bonds:  
tax expenditure
- #5. FHA guarantee: credit subsidy
- #6. Tax shelter:  
tax expenditures

SHFA = state housing finance agency

For enumeration of subsidies see text. Credit subsidies are discussed more fully in Section III.

If conventional mortgage financing is used, the developer (as he would in any sort of real estate development) will need both a construction and a permanent loan. The construction loan is a short-term loan (normally under 2 years) that provides the money needed to construct (or do substantial rehabilitation of) the building. Because the loan collateral (the building) is not in existence when the loan is given,<sup>124</sup> this is a risky loan. It is therefore expensive -- a construction loan on the conventional market from a commercial bank is normally several percentage points above the prime rate. In some states, however, a developer working with a state housing finance agency can get a somewhat cheaper construction loan through that agency, which can raise money more cheaply than can the conventional loan market because the state finance agency can issue tax-exempt bonds.<sup>125</sup> Every time a state agency issues tax-exempt bonds, the federal Treasury loses tax dollars it otherwise would receive if the bonds were taxable, (i.e. the Treasury makes a tax expenditure). Thus this is the second source of federal subsidy to a project involving conventional debt financing.

Once the project is fully constructed, it is in the developer's interest to pay off the construction loan as soon as possible and replace it with a lower-interest loan. (Once the building is completed, it is worth the amount of the loan; a lower interest loan will be available since less risk is involved.) Thus the developer replaces the construc-

tion loan with a "permanent loan" at a lower interest rate, usually from a savings and loan or an insurance company. The third and fourth forms of federal subsidy available to a project using conventional debt financing are used to lower the cost of the permanent loan. The third is Federal Housing Administration (FHA) mortgage insurance, available under Section 221(d)(3) and 221(d)(4). The mortgage insurance commits the federal government to repay the mortgage lender if the developer fails to do so. This transferring of risk from the mortgage-holder to the government ordinarily makes the mortgage-holder willing to lend money at a somewhat lower rate. The size of the subsidy is determined by complex calculations of the amount of risk transferred to the government.<sup>126</sup>

The fourth federal subsidy also reduces the cost of the permanent loan. Two different approaches are available: either the state housing finance agency offers permanent as well as construction financing via tax-exempt bonds, or the Government National Mortgage Corporation (GNMA) ("Ginnie Mae") offers an alternative source of subsidy. GNMA is a secondary mortgage market institution that works both to subsidize eligible permanent loans and to make mortgage money more readily available in times of shortage.<sup>127</sup> The secondary mortgage market consists of financial institutions that buy and sell permanent mortgage loans. GNMA combines this function with a

system for subsidizing certain types of mortgages. The subsidies derive from the fact that GNMA buys at or near face value mortgages that -- either because they are risky or because they carry lower-than-market interest rates -- are worth less than face value.<sup>128</sup> Of course, the difference between what GNMA pays for the mortgage and its worth on the market constitutes a federal subsidy.

In the place of conventional mortgage financing, a developer can choose to raise the money needed to cover the mortgage through "11(b) bonding." Section 11(b) of the housing act simply gives a private developer of low-income housing direct access to a municipality's ability to issue tax-exempt bonds. The actual financial structure set up when 11(b) bonding is used is bizarre. Take the case of a \$6 million project.<sup>129</sup> The developer goes to a municipal agency (call it the "Housing Agency"), with his proposed project. The agency, if it accepts the proposal, sets up a legal entity (call it the "Housing Agency Bonding Corporation") which it authorizes to issue its tax-exempt municipal bonds. The bond issue proceeds, but meanwhile the developer needs a construction loan, since the bond proceeds can be used for financing only after the collateral (the building) is in place.<sup>130</sup> So the Housing Agency Bonding Corporation borrows \$6 million<sup>131</sup> for the construction loan from a commercial bank; under federal law the bank is excused from paying federal income taxes on any income it receives as a result of that loan.



Meanwhile, of course, the developer is also paying the interest on the \$6 million bond issue. He is therefore paying interest on \$12 million, twice the amount he actually needs for the building. To limit his interest costs somewhat, he invests the \$6 million worth of bond proceeds in government-guaranteed securities until the building construction is completed and the money is needed for the permanent loan. The third, fourth and fifth forms of federal subsidy involved in a Section 11(b) project, then, flow from 3) the tax exemption given to the commercial bank on the construction loan, 4) the tax exemption for the municipal bonds, and 5) the government guarantees for the investment in securities.

The final type of federal subsidy given to a typical low-income housing project today is the tax shelter. In theory, the shelter helps developers raise equity money needed to attract a mortgage; in fact, the proceeds from syndication provide an up-front fee for the developer.

## 2. Inadequacy of the CBO study's "translation" approach

By focusing political attention on the funding format of one of the six subsidies used in lower-income housing projects, the CBO study in effect endorses the present housing strategy. This passive endorsement derives from the narrow translation approach of tax expenditure analysis developed in the context of tax reform. It made sense for tax reformers to focus on tax expenditures one by one<sup>132</sup>, and to concentrate

on translating into direct subsidies those they could not simply abolish. This approach no longer makes sense, however, now that tax expenditure analysis is being used by budget reformers, not for tax reform but as the basis for restructuring housing programs.

a. Impact of the CBO study's translation approach: tax and budget goals

The first drawback of the CBO study's narrow translation approach derives from the fact that it concentrates not on the current low-income housing strategy considered as a whole, but on some of the individual programs that comprise that strategy. This inability to see the forest through the trees means that, even if one individual tax-expenditure program (the tax shelter) was translated into a direct subsidy, the overall low-income housing strategy of which tax shelters are but one constituent part still would not meet either tax- or budget-reform goals. Tax-reform goals would not be met because housing projects would continue to employ a range of tax expenditures. The most important of these is the subsidy that derives from the sale of tax-exempt municipal bonds. The size of this expenditure dwarfs that for tax shelters: in 1978, \$600 million<sup>133</sup> was spent on municipal bonds, whereas only \$150 million<sup>134</sup> was spent on tax shelters, that benefited low-income projects.

Even if tax shelters were translated into direct subsidies, the present low-income housing strategy would continue to rate very low from the perspective of the budget-reform

goals of visibility of expenditures and cost efficiency. Even if the tax shelter were translated into a direct subsidy, lower-income housing projects still would utilize so many complex and hidden subsidies that virtually no one except real estate developers and their accountants, bankers and lawyers would be able to understand the amount of government funds involved. Moreover, the "mix and match" character of the various subsidies would continue to make it extraordinarily difficult to calculate the cost efficiency of the current housing strategy as a whole, or of any particular combination of subsidies. Figure 2 illustrates that it is possible to combine different housing subsidies into over twenty permutations. In order to calculate the average cost per unit of any one of these permutations, one would need calculations of the amount of subsidy used from each of the various funding sources (e.g. Section 8, tax shelters, etc.). No such figures exist or are likely ever to exist; therefore, detailed calculations of cost efficiency are impossible.<sup>135</sup> Yet the description in II.A.1. points to massive cost inefficiencies in many of the possible permutations: for example, in projects using Section 11(b) bonding, a developer must borrow and pay interest on loans for twice the actual cost of his housing project.

A different aspect of the inefficiency of the present housing strategy stems from the fact that very substantial direct expenses and time delays (which cause further expense) result because so many sources of funding must be applied for

Figure 2: low-income housing production subsidy programs

Section 8: New construction/substantial rehabilitation:

basic format: Section 8, subsidy construction  
loan, permanent loan, FHA mort-  
gage insurance, tax shelter

6 basic permutations

#1. new construction Section 8 market rate construction loan GMNA permanent loan FHA mortgage insurance tax shelter - acc. dep.	#2. Subst. rehab. same same same tax shelter-167(k)
#3. new construction Section 8 SHFA construction loan GNMA permanent loan FHA mortgage insurance tax shelter - acc. dep.	#4. Subst. rehab. same same same tax shelter-167(k)
#5. new construction Section 8 11(b) bonding (entails: market-rate construction loan GMNA guarantee of mortgage- backed bonds tax-exempt bonds to finance permanent mortgage) FHA mortgage insurance tax shelter-acc. dep.	#6. Subst. rehab. same same same tax shelter-167(k)

Section 236: 8 basic permutations:

Basic format same as under Section 8: permutations #1-#4  
(tax-exempt bond financing of permanent mortgage not avail.)  
Two programs: Sect. 236 alone, and Sect. 236 combined with  
rent supplements.

Section 202: 6 basic permutations:

Can be combined with Section 8.

Public housing: 1 basic permutation:

Basic format: tax-exempt bonding finances debt service  
government guarantees of those bonds  
operating subsidies

Other programs: Section 235: Rural Housing Insurance and  
subsidies:  
community development block grants.

N.B. Only federal subsidies are included. Virtually all  
projects also receive local property tax forgiveness.

and coordinated in a single program. If the recommendation of the CBO study -- that the proposed builders' credit should be granted automatically -- were implemented, the situation would not be made worse, but neither would it be improved, since all the requirements surrounding Section 8 and either conventional or Section 11(b) financing would remain.

b. Impact of the CBO study's translation approach on housing reform

Now that tax expenditure analysis is being used by budget reformers to restructure housing programs, a new version of tax expenditure analysis must be developed. Tax expenditure analysis must be melded with housing policy analysis: two combinations suggest themselves, and they will be discussed below. But first it is necessary to provide a brief sketch of the current lower-income housing strategy and of the role tax expenditures play in it.

1) The role of tax expenditures in a lower-income housing strategy based on "passive intervention" production subsidies

The present approach to lower-income housing was instituted in the mid-1960s; it was the first major overhaul in low-income housing programs since 1937. From 1937 - 1965 public housing had been the primary program for channeling government subsidies into low-income housing. The public housing program was an "active intervention" approach, in which the government itself built and owned the housing. The local public housing authority acted as its own developer, hiring its own architect and contractor; its own banker, raising mortgage money through municipal bonds; and its

own manager of the buildings after completion.

In sharp contrast to the low-income public housing program, middle-income housing programs left intact the system of private actors involved in residential construction. In the middle-income programs, the government neither built nor managed the housing; it merely provided support and subsidy to private actors, who produced the desired housing through the market. FHA mortgage insurance, VA mortgage guarantees, the secondary mortgage market and homeowner deductions all are examples of this "passive intervention" approach.<sup>136</sup>

In the mid-1960s, low income housing programs were re-evaluated as a result of the new focus on poverty that also simultaneously affected tax policy.<sup>137</sup> At the time of this re-evaluation, consensus was that, while public housing was a "dreary deadlock" and a dismal failure,<sup>138</sup> the passive intervention programs for the middle class had been impressively successful.<sup>139</sup> The reaction was to apply the passive intervention approach to low-income housing. A series of programs replaced local public housing authorities with private developers and/or landlords in 1965.<sup>140</sup> But the line of programs that was to develop into the major thrust of low-income housing policy after 1968 began with the Section 221(d)(3) rent supplement program.<sup>141</sup> Section 221(d)(3) originally was an interest subsidy program which completely eliminated the local housing authorities. It provided for private developers to build housing for the lower-middle class,

offering 3% 40-year loans in a 6% 20-year market.<sup>142</sup> When Congress decided to retarget Section 221 (d) (3) to the poor, it was quickly discovered that even with interest subsidies, it was not economic for developers to rent Section 221(d) (3) projects at prices the poor could afford. To remedy this, rent supplements were passed, providing direct subsidies to be used to make up the difference between 25% of eligible tenants' incomes and the actual project rent. The rent supplements, however, were not passed without an uproar that astonished most observers then and has ever since.<sup>143</sup> As Henry Aaron remarked dryly in 1973, "[t]he program has not been a Congressional pet." Very few units of rent supplement housing have ever been built.<sup>144</sup>

Consequently, when the second generation of passive intervention programs targeted to the poor was developed, the rent supplement approach was abruptly dropped. Instead, the Great Society programs, Section 235 and Section 236,<sup>145</sup> offered a larger interest subsidy: they provided for 1% loans in a 6.5% market.<sup>146</sup> Even with the interest subsidy, however, still more subsidy was needed to make the housing economically feasible. In Section 236 projects<sup>147</sup> this gap was filled by tax subsidies, channeled through the tax shelter. Syndication of tax benefits quickly became the norm in Section 236 projects, once given an initial push by the National Housing Partnerships enacted simultaneously with Section 236.<sup>148</sup> In 1969, of course, Section 167(k) offered a 5-year write-off of rehabilitation expenditures that gave some projects

access to more tax shelter than ever.<sup>149</sup> In effect, then, tax expenditures replaced rent supplements in propping up the passive intervention approach to low-income housing.

The alliance between developers and low-income housing advocates that resulted from the shift to a passive intervention approach proved so successful that, once Section 235 and Section 236 were geared up, production boomed. In the five years between 1969 and 1973, as many federally subsidized units were built as were built in the previous 34 years.<sup>150</sup> This boom ended abruptly with Nixon's moratorium on housing programs in 1973.<sup>151</sup>

During the upheaval that followed, Section 236 was transformed into Section 8. Section 8 represents a complete abandonment of the interest subsidy,<sup>152</sup> and in theory represents an abandonment of the underlying assumption that governmental intervention in low-income housing should take the form of subsidies for production of new housing.<sup>153</sup>

Section 8 offers increases in both direct and indirect subsidies. The direct subsidy, determined as the difference between the rents paid by eligible low-income tenants (about 25% of their income) and the market rent of the project, normally is higher than the subsidy that would have been available under a Section 236 interest subsidy.<sup>154</sup>

Indirect subsidies also multiplied. While a typical Section 236 project used only the Section 236 interest subsidy, FHA guarantees and the tax shelter,<sup>155</sup> the typical Section



8 project utilizes up to five different forms of indirect subsidy in addition to Section 8 funds.<sup>156</sup> The most important of the indirect subsidies made available to Section 8 projects is the interest subsidy, which is not as large as that used in Section 236, but is offered in addition to Section 8.

Two types of interest subsidy are given by means of tax subsidies. First, Section 11(b),<sup>157</sup> enacted simultaneously with Section 8, gives Section 8 projects access to subsidized mortgage money by allowing the mortgage loan to be financed through tax-exempt bonding.

Second, state housing finance agencies have become much more effective as conduits of federal tax subsidies. Prior to 1973, most state agencies had not yet been very active because they were just starting up: only 11 had issued any bonds at all as of 1973.<sup>158</sup> By now many more state housing finance agencies have come of age, as is evident by the dates of their founding: only one existed before 1960; 11 more were established in the late 1960s; 14 more between 1970 and 1972; in 1973, state housing finance agency legislation was pending in 10 states.<sup>159</sup>

The third type of interest subsidy is channeled not through tax-exempt bonds but through the secondary mortgage market. A Section 8 project can receive a subsidized mortgage through GMNA, which would (for example) commit itself to buy a 7.5%<sup>160</sup> mortgage in 1978 when the market interest rate was about 9%.<sup>161</sup>

No comprehensive figures exist to document the rise in subsidy per unit of each successive passive intervention program. Those figures that do exist for production subsidy programs seriously underestimate their costs, since large proportions of all projects have defaulted (or can be expected to do so in the future).<sup>162</sup> Upon default, FHA guarantees require the federal government to pay off the bank holding the loan and to incur the mortgage liability itself. In effect, the loan guarantee ordinarily calculated to involve minimal expense to the federal government becomes a huge federal subsidy equal to the amount of the mortgage loan.<sup>163</sup>

Those figures that do exist suggest that cost per unit has risen consistently since the passive intervention approach was introduced. The rent supplement program cost \$1310/unit (1972 dollars) in 1973.<sup>164</sup> Section 236 cost \$2500/unit (1973 dollars) in 1973;<sup>165</sup> but that excluded all default costs, and one-fourth of all Section 236 projects have now defaulted.<sup>166</sup> Section 8/New Construction and Rehabilitation projects cost \$4000/unit (1976 dollars) in 1976, excluding any future increase due to defaults.<sup>167</sup>

2) Tax expenditure analysis and reform of low-income housing programs

Once the translation approach to tax expenditure analysis is discarded in favor of an approach that melds analysis of tax expenditures and analysis of housing policy, two

combinations of tax expenditure analysis and housing policy analysis suggest themselves.

First, tax expenditure analysis could be used to fine-tune the system of passive intervention production subsidies. The CBO study begins this process, although instead of the traditional tax reform approach of translating tax expenditures one by one, the entire system of subsidies needs to be reassessed and simplified. One major argument in favor of this fine-tuning approach is the claim that the only way to obtain enough money for lower-income housing is to retain the passive intervention approach (so that private bankers and developers will lobby for it) while hiding the actual amounts of subsidy involved (to avoid an uproar such as happened with the rent supplement program).

The other major alternative<sup>169</sup> would be to use tax expenditure analysis to argue that the present system of production subsidies should be abandoned. The most persistent and articulate opponents of production subsidies are those who advocate a shift to housing allowances, whereby truly low-income people would be given an earmarked income transfer and left to rent housing on the open market.

A shift from production subsidies to a housing al-

lowance would satisfy the goals of tax expenditure analysis, since a housing allowance approach would eliminate all extant tax-expenditure lower-income housing programs. This is true because the tax expenditures benefiting lower-income housing have since their inception been related to the capital formation aspect of housing construction, as the history of tax expenditures for housing presented in Section I illustrates.<sup>170</sup> A switch away from production subsidies would represent a final abandonment of the effort to adopt policies developed in a capital formation context to meet welfare goals.<sup>171</sup>

A housing allowance by definition could not be channeled through the tax system. It would clearly be unsuitable to offer deductions to potential beneficiaries, since the higher one's income, the larger the government subsidy offered via a deduction of a given amount.<sup>172</sup> Tax credits would not be suitable either, since many of the potential housing allowance beneficiaries would pay such low taxes that a credit would be worthless to them.<sup>173</sup> The only feasible tax expenditure format would be the refundable credit, now being advocated by Surrey as the second-best solution if a direct subsidy is not politically possible.<sup>174</sup> A refundable credit housing allowance, however, would seriously strain the fiction of using the tax system. In effect, the government would send housing allowance checks from the Treasury rather than from HUD; since all the beneficiaries would be low-income and

would pay only a small amount of taxes, the program would obviously be a thinly veiled direct subsidy program. Hence, it is likely that a housing allowance would be in the form of a direct subsidy; introduction of a housing allowance most likely would eliminate tax expenditures for low-income housing in one fell swoop.

Because a shift to housing allowances would eliminate all extant tax-expenditure programs for lower-income housing, an alliance between housing allowance proponents and tax expenditure analysts should appeal to budget reformers. Such an alliance also should appeal to housing policy analysts who favor the housing allowance, because a "full accounting" of all tax expenditures could re-inforce two major arguments against a production-subsidy approach. Both arguments stem from the fact that production subsidies require very large amounts of subsidy per unit. The first argument is that the high subsidies per unit required by a production subsidy approach produce horizontal inequity among those eligible for housing benefits.<sup>175</sup> The radical (and constantly growing) mismatch between what a low-income tenant can afford to pay and what a new unit costs to build means that a production-subsidy program must give a large amount of subsidy (in the form of a new housing unit) to a small proportion of those eligible for the housing program.

The second argument against production subsidies is that the same mismatch between the cost of a new unit and low-income

tenants' incomes also prevents production-subsidy programs from serving the lowest-income population. In order to make projects economic, program designers have found it necessary to target production subsidies to beneficiaries who can pay more rent than can truly low-income people. Thus in 1977 the median income in Section 235 housing was \$8,085; in Section 236 housing the median was \$6285; in Section 8 New Construction/Substantial Rehab it was \$4376.<sup>176</sup> By contrast, the average income of people who participated in programs that utilized existing housing was lower. The median income of families in Section 8 Existing Housing was \$3506;<sup>177</sup> the median income of families who participated in an experimental housing allowance program was \$4000 (in 1978).<sup>178</sup>

If budget reformers choose to use tax expenditure analysis to argue in favor of housing allowances, they should be aware of other major arguments against production subsidies. In addition to eliminating the problems associated with costs, a shift away from production subsidies seems to offer the possibility of targeting money for housing to people with very low incomes without creating the "problem projects" that had by the 1970s become a serious urban problem. A thriving literature documented the syndrome of vandalism and crime that overtook a very visible percentage of urban "projects."<sup>179</sup> The literature added new urgency to the claim that the poorest families should not simply be thrown together.

These considerations were reinforced by a growing conviction that production subsidies had important technical drawbacks. This strain of thought derived from "submarket analysis," an approach initiated in the early 1960s,<sup>180</sup>

which argued that in order to tell what would be the impact of producing new housing units, it was necessary to understand the workings of different housing submarkets within a metropolitan area. For example, if new subsidized units were produced in a city in which there was already an excess of low-income housing, the net result might well be the decline of low-income neighborhoods caused by the abandonment of existing housing.

Tax- and budget-reformers should also be aware of major arguments against the housing allowance. The first is the claim that because a housing allowance, even if it could ever be enacted, would be politically more vulnerable than the present passive intervention programs, lower-income people would end up with less housing subsidy than ever. The second criticism involves a technical problem. If the elasticity of supply of low-income housing is low, then a large-scale program of housing allowances would serve only to drive up rents without any substantial increase in the quality of the housing low-income people could afford. Unfortunately, no study has been able to determine whether the elasticity of low-income housing supply is high or low.<sup>181</sup>

### 3. Conclusion

The narrow translation approach used by the CBO study was suitable when tax expenditure analysis was being used for tax reform, but it is not suitable as the background for restructuring housing and other expenditure programs. The

mandate of the Congressional Budget Act to integrate consideration of tax expenditure and direct subsidy programs could have an undesirable impact on reform of housing programs unless the translation approach is replaced with a new form of tax expenditure analysis that integrates tax- and budget- with housing policy-reform goals. In this section we have seen the way the narrow translation approach distorted the CBO study's analysis of low-income housing expenditures; the next section examines how the CBO study in effect focuses attention away from what ought to be the major focus of tax expenditure analysis of housing policies because of the study's origins in the tax reform movement.

B. The CBO study's treatment of the distribution of housing subsidies between the poor and the nonpoor.

The way the CBO study uses tax expenditure analysis has serious drawbacks from the standpoint of low-income subsidies. Unfortunately, these are matched by the study's drawbacks as a tool for equalizing the allocation of housing subsidies between the poor and the nonpoor.

As was explained above, the scope of the CBO study -- the decision to concentrate on tax shelters alone -- was determined by Congress' mandate to the CBO. Congress expressly forbade the CBO<sup>from</sup> considering homeowners deductions. In its letter directing the CBO to write what became Real Estate Tax Shelter Subsidies and Direct Alternatives, the Congress outlined the proposed changes in the tax law then under



consideration and made oblique reference to HUD's concern over the impact of tax reforms on lower-income housing production. Its instructions to the CBO were as follows:

Accordingly, we believe it would be a helpful first step for the Congressional Budget office to undertake a study of possible alternative or additional rental housing subsidies which could substitute for existing tax shelter subsidies. Such a study would not deal with the separate issue of subsidies for homeowner-ship, such as the tax deductions for home mortgage interest and property taxes.<sup>182</sup>

This shows clearly the tax reform context in which the scope of the CBO study was defined. The study grew out of tax reformers' past successes in attacking the tax shelter. Congress' mandate to the CBO made explicit the alliance between political pragmatists and tax reformers in concentrating on tax shelters while carefully avoiding any challenge to homeowner deductions.

The tax reformers decided to attack tax shelters but not homeowner deductions (despite the fact that both are tax expenditures) because they naturally focused on the distribution of tax expenditure benefits among tax beneficiaries. And tax shelters had a far more regressive impact on tax beneficiaries than did homeowner deductions. Figure 3 is a typical tax reform analysis of the impact of tax shelter and of homeowner deductions. It shows that 40-50% of the tax benefits from homeowner deductions accrue to taxpayers with incomes below \$10,000, whereas 70% of the tax benefits from tax shelters accrue to those with incomes above \$10,000.

Figure 3: Tax reformers' analysis of the distribution of tax beneficiaries of tax shelters\* and homeowner deductions.

Income Groups	Homeowner Deductions		Tax Shelters
	Deduction of Mortgage Interest	Deduction of Property Taxes	
Less than \$5000	6.8%	7.7%	10.4%
\$5-10,000	41.4	33.3	21.3
\$10-15,000	42.7	43.7	34.1
Over \$15,000	9.1	15.3	34.1
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

\* Depreciation on rental housing in excess of straight-line is used as an approximation of the tax shelter.

Source: S. Surrey and P. McDaniel, The Tax Expenditure and the Budget Reform Act of 1974, 18 B.C. INDUST. and COM. L. REV. 679, 733-6.

In addition to the fact that tax shelters were more regressive than were homeowner deductions, tax reformers recognized that Congress generally considered homeowner deductions politically unassailable.<sup>183</sup> These two considerations formed the basis of tax reformers' decision to focus reform efforts on the tax shelter.

The unspoken decision to concentrate on shelters rather than homeowner deductions made sense when the expenditure analysis was the preserve of tax reformers. It no longer makes sense in the new context of budget and housing policy. If tax expenditure analysis is to be used to restructure housing programs, attention must focus not only on the tax beneficiaries of tax expenditure programs but also on those programs' housing beneficiaries. This change in perspective changes the evaluation of tax shelters versus homeowner deductions, since homeowner deductions (although less regressive than tax shelters from the standpoint of tax beneficiaries) are far more regressive from the standpoint of housing beneficiaries in that they make the overall pattern of housing expenditures spectacularly regressive. In fact, approximately 80% of federal housing expenditures go to the nonpoor.<sup>184</sup> According to the CBO's own figures \$10.2 billion went in FY 1978 for homeowner deductions,<sup>185</sup> 68 times more than the \$150 million spent for tax shelters to benefit low-income housing.<sup>186</sup>

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diverge most sharply on the issue of how housing benefits are distributed between the poor and the nonpoor. Therefore, this is an important issue to address in an attempt to integrate tax expenditure analysis into an analysis of housing expenditures (as the basis for restructuring housing programs). The only recent legislative attempt to reformulate homeowner deductions was the 1974 proposal of Senator Edward Kennedy (who is a leading tax reformer in Congress) to translate the mortgage interest deduction into a tax credit.<sup>187</sup> This proposal is in the mainstream of Surrey's present version of tax expenditure analysis, which focuses attention on translating tax expenditures into other tax expenditures with less regressive impact as a second-best solution when it is judged politically impossible to abolish the tax expenditure completely or to turn it into a direct subsidy.<sup>188</sup> Translating the mortgage interest deduction into a tax credit would make it less regressive in terms of its impact on tax beneficiaries.<sup>189</sup> However, a narrow translation approach would not address the core housing policy issue involved, since the mortgage interest subsidy would most likely still constitute the largest single federal housing program, most of whose benefits would go to nonpoor beneficiaries (because most of the poor are renters, not homeowners).<sup>190</sup>

A better mesh of tax-, budget- and housing policy-reform goals would be to mobilize tax and budget reformers' distaste for homeowner deductions in a longer-term strategy to abolish the deductions completely. This goal is fast becoming less

and less impractical because of tax reformers' success in raising the standard deduction,<sup>191</sup> and because of trends in housing prices.

Traditionally, federal homeownership policies<sup>192</sup> have been thought of as programs for the middle class, particularly the lower middle class. Throughout the 1950s the middle and lower-middle class did receive massive amounts of federal assistance.<sup>193</sup> Partly as a result of this assistance, a revolution in homeownership took place in the U.S. between 1900 and 1960. In 1900 a relative elite one-third (37%) of urban households owned their own homes; by 1960 nearly two-thirds did.<sup>194</sup> During approximately the same period, construction of rental units dropped precipitously from 43% of new dwelling units in 1927 to only 9% in 1955.<sup>195</sup> The most dramatic growth of homeownership was after World War II. Said one contemporary observer, "The extraordinary growth of homeownership is one of the outstanding characteristics of the postwar United States."<sup>196</sup> At the end of the war, only 16 million nonfarm households owned their own homes (50% of the population); a decade later in 1956, that number had doubled to 30 million (60% of the population).<sup>197</sup> The postwar spurt was fueled by capital saved up during the war and by pent-up demand that had been building up during the Depression.<sup>198</sup> It was helped by two massive governmental programs focused primarily on the middle- and working-classes: FHA mortgage insurance and VA mortgage guarantees. One

estimate is that 35 - 50% of postwar residential construction (1946 - 1977) was built under the two programs;<sup>199</sup> a more conservative estimate is 15%.<sup>200</sup>

Limitations on mortgage size<sup>201</sup> ensured that FHA benefited primarily the lower-middle class. In addition, the subsidies hidden in FHA insurance were small.<sup>202</sup> The VA program, however, had no limitations on mortgage amount,<sup>203</sup> and hid very substantial interest-rate subsidies.<sup>204</sup>

After 1946, when the income tax became a substantial economic factor, large subsidies began to flow through the income tax system via homeowner deductions. No figures exist for the percentage of taxpayers electing homeowner deductions during this period, but it is possible to get an idea of the number of taxpayers taking homeowner deductions by counting how many taxpayers elected to itemize rather than taking the standard deduction.<sup>205</sup> In 1964, only 4% of all taxpayers took the standard deduction,<sup>206</sup> and this percentage stayed relatively constant until 1967.<sup>207</sup>

With the onset of the tax reform movement, however, this percentage began to rise sharply, as tax reformers pushed successfully for higher standard deductions in an attempt to encourage people to take the standard deduction.<sup>208</sup> The three charts in Figure 4 show the result of the tax reformers' strategy of raising the standard deduction. In 1969, before the first Tax Reform Act took effect, roughly half of taxpayers itemized and half did not (See Chart A). Nearly 20% of Americans with incomes below \$5000 itemized, as did over half

Figure 4\*

Chart A: Percentage, distribution, by income groups, of taxpayers who itemize

Income Class	1969 <sup>1</sup>		1973 <sup>2</sup>		1977 <sup>3</sup>	
	Itemized	Standardized	Itemized	Standardized	Itemized	Standardized
All taxpayers	46%	54%	35%	65%	26%	68%
Below \$5000	18	82	5	94	2	98
\$5-10,000	53	47	28	72	8	92
\$10-15,000	74	25	48	51	22	78
\$15-20,000 or over \$20,000	70	10	77	24	40	60
Over \$20,000					73	27

Chart B: Distribution among income groups of the benefits of itemization

Income Class	1969 <sup>4</sup>		1973 <sup>5</sup>		1977 <sup>6</sup>	
	Itemized	Standardized	Itemized	Standardized	Itemized	Standardized
Below \$5000	7%	34%	2%	31%	0.5%	21%
\$5-10,000	16	15	7	18	1.7	21
\$10-15,000	13	5	10	10	3.5	13
\$15-20,000 or over \$20,000	10	1	17	5	5.2	8
Over \$20,000		100%		100%	15%	6
						100%

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Chart C: Distribution of tax benefits from homeowner deductions - 1976

Income Class	Proportion of tax benefits accruing for each income class
Under \$5000	0.7%
\$5-10,000	6
\$10-15,000	16
\$15-20,000	24
Over \$20,000	54
	100%

Sources for Figure 4:

- <sup>1</sup>INTERNAL REVENUE SERVICE, U.S. DEPT. TREASURY,  
INDIVIDUAL INCOME TAX RETURNS FOR 1969, 82 (19 )  
(hereinafter cited as INDIVIDUAL RETURNS-YEAR)).
- <sup>2</sup>INDIVIDUAL RETURNS - 1973, 39.
- <sup>3</sup>INDIVIDUAL RETURNS - 1977, 34.
- <sup>4</sup>Calculations based on data from INDIVIDUAL RETURNS - 1969,82.
- <sup>5</sup>Calculations based on data from INDIVIDUAL RETURNS - 1973,39.
- <sup>6</sup>Calculations based on data from INDIVIDUAL RETURNS - 1977,34.
- <sup>7</sup>U.S. DEPT. HOUSING & URBAN DEVELOPMENT, HUD STATISTICAL  
YEARBOOK - 1977, 348 (Table 15) (1977).

\* Totals may not add up to 100% due to rounding.



of those with incomes between \$5 - 10,000 and nearly three-fourths of those who earned between \$10 - 15,000. In 1973, four years after the first Tax Reform Act, the proportion of taxpayers who itemized had dropped to roughly one-third; this percentage dropped further (to one-fourth) after the second Tax Reform Act of 1976. By 1977, the percentage of people with incomes below \$5000 who itemized had fallen from 20% (in 1969) to 2%; the percentage of those with incomes between \$5-10,000 who itemized had fallen from over 50% to 8%; about 20% (down from 75%) of Americans with incomes between \$10-25,000 now itemized. Another useful perspective is given by Chart B, which shows the total percentage of all itemizers that came from each income group. Chart B shows that whereas in 1969 36% of the benefits incident to itemizing went to those with income below \$15,000, by 1977 only 6% still did.

Documentation of the number of taxpayers electing homeowner deductions is available for 1976. This data confirms that changes in the tax law have meant that the traditional claim that homeowner deductions benefit the middle and working class is no longer true. Chart C shows that in 1976 only 0.7% of all returns filed by people with incomes below \$5000, and only 6% of those filed by people with incomes between \$5 - 10,000, took homeowner deductions. Even expanding the definition of lower-middle class to include people with incomes below \$15,000 scarcely makes homeowner deductions less regressive, since only 16% of this group claimed these deduc-

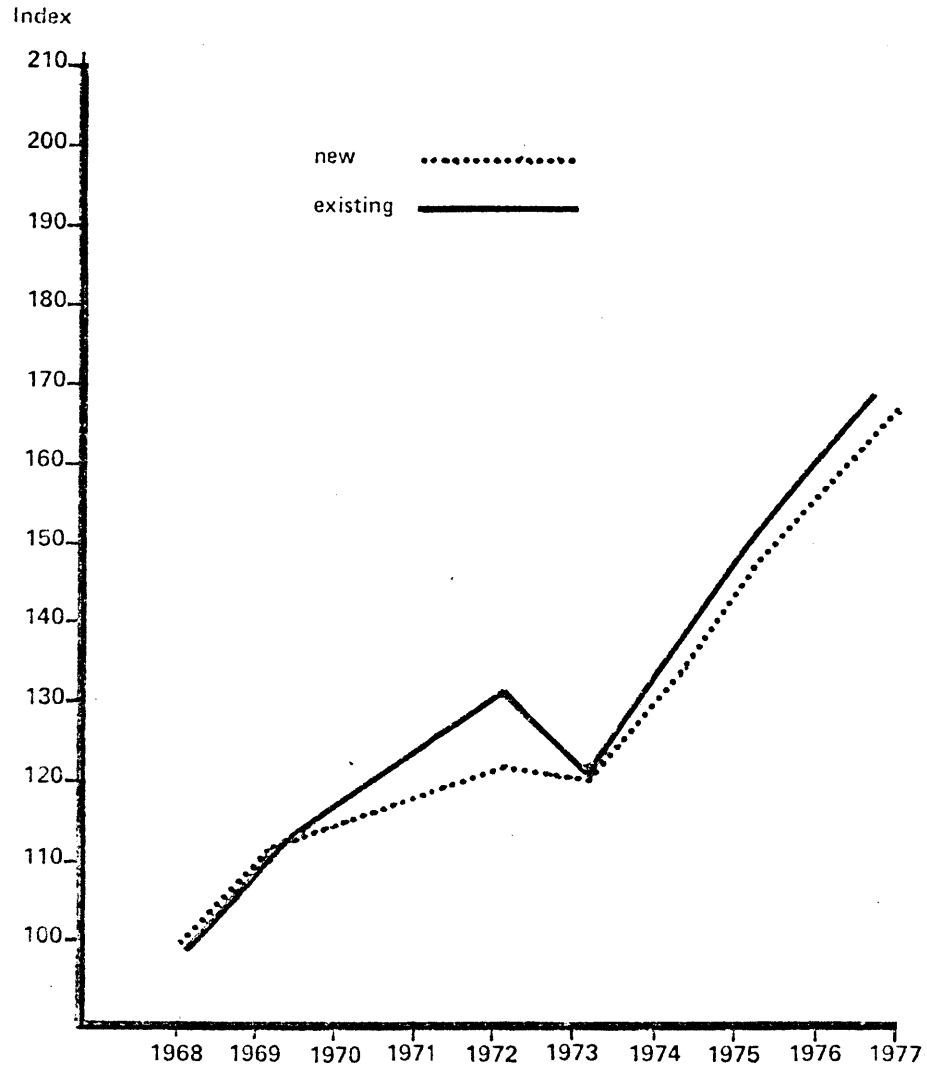
tions. Chart C also shows that nearly 95% of the benefits of homeowner deductions accrue to taxpayers with incomes over \$10,000 (nearly 80% of those with incomes over \$15,000).

The traditional claim that homeowner deductions benefit primarily the middle and lower-middle class has become obsolete not only because of tax reforms (i.e. rises in the standard deduction) but also because of recent changes in the price of single-family homes.<sup>209</sup> Sharp rises in housing prices have meant that the benefits given to an average beneficiary of the homeowner deductions have increased at the same time as the base of beneficiaries has constricted.

Figure 5 illustrates the rise in housing prices since 1968. This price rise has had two effects. First, it has begun to lock lower-income owners out of the market for new housing. Whereas close to half of American families could afford a median-price new home in 1970, by 1970 the proportion had fallen to one-quarter.<sup>210</sup> In addition, the rise in housing prices has meant that those who can afford to buy houses now characteristically buy more expensive housing in relation to their incomes than had traditionally been the practice,<sup>211</sup> because the house is viewed as an inflation-proof investment. A 1979 study reports:

One of the clearest and most significant findings pertains to the great role of investment and related financial considerations in the purchase decisions of 1975 and especially 1977 buyers. Home purchase as (1) an inflation hedge, (2) an opportunity to capture larger income-tax benefits, and (3) the "best investment for the money" ranked very high among the responses [to surveys taken].<sup>212</sup>

Figure 5: Rise in Price of Single-Family Houses  
1968 - 1977.



SOURCE: L. Grebler & F. Mittelbach, The Inflation of Housing Prices, p. 17.

As the study indicates, the availability of homeowner deductions enhances the attractiveness of investing in housing.<sup>213</sup> Moreover, the more expensive the home in relation to the taxpayer's income, the more valuable are the tax benefits available: a taxpayer earning \$50,000 who deducts \$500/month on an \$80,000 home receives greater tax benefits than if the same taxpayer deducted \$300/month on a \$50,000 home.<sup>214</sup> Homeowner deductions are turning into a tax shelter for the upper-middle class.

When the decline in the numbers of lower-middle class taxpayers who elect homeowner deductions is combined with the rise in the amounts deducted by upper-middle class taxpayers electing the deductions, it becomes clear that the regressivity of homeowner deductions is increasing sharply. This fact suggests that the home deductions should now be much more vulnerable to attack than they traditionally have been. Tax reformers traditional focus on tax shelters, and their fatalistic acceptance of homeowner deductions should be reassessed and the elimination of the mortgage interest deduction should be a very high priority of tax-, budget- and housing policy-reform.

Although the time is ripe for reform of the mortgage interest deduction, an attempt to change the second homeowner deduction -- the deduction of local property taxes -- presents additional political problems. It has long been clear that the homeowner property tax deduction functions to allow

local governments to transfer their expenses to the federal government: local governments enact increases in property taxes while publicly assuring taxpayers that they are in effect taxing the federal government to pay for local expenditures.<sup>215</sup> The political significance of this fact was confirmed when recent attacks on the homeowner deductions met with resistance from a coalition in which municipal governments played a prominent role.<sup>216</sup> Any attack on homeowner deductions therefore should concentrate initially on the mortgage interest deduction (as did Senator Kennedy's). A challenge to the property tax deduction must be preceded by a study that develops a substitute program that transfers revenue from the federal to local governments.

III. From tax expenditure analysis to analysis of all "backdoor expenditures"

Section II focused on the need to adapt the version of tax expenditure analysis developed in a tax-reform context to its new role in restructuring housing programs. Section III will argue that, when the focus is on reform of housing programs, tax expenditure analysis has inherent limitations.

When Surrey introduced the concept of "tax expenditures " in 1967, he did so amidst a good deal of ferment. As Surrey at the Treasury spoke of "tax expenditures," Chairman of the House Ways and Means Committee Wilbur Mills spoke of "back door spending,"<sup>217</sup> and the President's Commission on Budget Concepts issued its final report.<sup>218</sup> The Commission on Budget Concepts took the broadest perspective. Instead of focusing specifically on tax expenditures, it focused on all three major varieties of "backdoor expenditures": tax expenditures, credit activity, and programs involving what are now referred to as "uncontrollable" expenditures. (Expenditures are uncontrollable in programs that are open-ended or involve fixed costs or long-term contracts because in such programs Congress does not have the ability to control program costs in a given year, since prior commitments require the government to appropriate money to cover its obligations.)

Thus final Section of the paper first will examine

the two forms of backdoor subsidy that are left out by tax expenditure analysis. Section III.A discusses the need for an accounting of costs associated with the credit activity of the federal government. The 1981 Budget<sup>219</sup> for the first time implements the recommendation of the 1967 Commission on Budget Concepts that the Budget should reflect costs of credit activity. The recognition that credit activity can involve major costs is an important insight if the traditional budget-reform goal of providing "a full accounting" is to be achieved. It is especially important in accounting for housing programs to include costs of credit activity because the major housing programs for the nonpoor<sup>220</sup> have been credit programs, whereas housing programs for the poor have been dependent upon tax expenditures and direct subsidies. Traditional tax expenditure analysis, therefore, has tended to focus on providing a full accounting of the costs of housing programs for the poor, while overlooking potential costs of housing programs for the nonpoor.

While the credit accounting provided in the 1981 Budget represents an important addition to traditional tax expenditure analysis, the Budget's treatment of credit has two important drawbacks. First, because of the exemption of certain housing programs from the credit control system, the system is likely to work in the long term to make housing programs more regressive. Second, the Budget's accounting of credit outlays has limited usefulness as the basis for restructuring housing programs because the

system does not calculate how much subsidy is hidden in credit programs. Without such calculations, it is impossible to compare the cost efficiency of credit programs with programs that use a different funding approach; with tax expenditure or direct-subsidy programs. Section III.A concludes by discussing the effects on program design of using a credit approach to housing programs.

Section III then proceeds to discuss the third major kind of backdoor expenditure. Section III.B contests the characterization of direct subsidies presented in tax expenditure analysis, which assumes that direct subsidies are the ideal funding format, in contrast the "invisible and unaccountable" tax expenditures. Section III.B shows that the major direct-subsidy programs for housing have involved "uncontrollable expenditures" structured to disguise the level and type of the financial commitment that has been made. Thus the goal of budget reform should not be defined in terms of translating tax expenditures into direct subsidies. Instead, budget reformers should concentrate on making all expenditures visible and accountable no matter what their funding format.

The paper ends with an attempt to gain historical insight into the question of why backdoor expenditures have been such a persistent feature of American domestic policy in general and of housing policy in particular. Section III.C shows that, since the Civil War, backdoor expenditures have helped to resolve a basic contradiction



in American politics, between 1) the desire to effect social goals through market mechanisms by giving "incentives" to private actors and 2) the taboo against giving private actors public funds which they use for private gain (even in the form of "incentives").

#### A. The role of credit in housing policy

The amount of money involved in tax expenditures for housing (other than homeowner deductions) pales beside the huge amounts of money involved in federal credit assistance for housing. This section first outlines the three primary forms of federal credit activity and gives an indication of the amounts of money involved. It then describes the failure of budget reformers to institute a system that would account for and control federal credit expenditures during the period when tax expenditure analysis was gaining a political foothold. The discussion then focuses on the system of accounting for and controlling federal credit expenditures that was introduced in the 1981 Budget. The final subsection presents a brief evaluation of the approach taken in the Budget.

##### 1. Major types of credit programs benefiting housing

There are three basic types of credit programs that benefit housing. The most straightforward programs entail direct loans from the government. These are also the least common: the small VA direct loan program and the

low-interest loans given under Section 221 are examples.

The second major type of government involvement in housing credit operates through the secondary mortgage market. The three secondary mortgage market entities are GNMA, a government agency that deals primarily in federally subsidized mortgages; FNMA, an off-budget semiprivate corporation that deals traditionally in FHA and VA mortgages; and the Federal Home Loan Mortgage Corporation (FHLMC) ("Freddie Mac"), founded in 1970 to deal in conventional mortgages. All buy and sell permanent mortgage loans. This activity can increase or decrease the overall flow of funds to mortgages.<sup>221</sup> It can also channel interest subsidies to certain types of loans.

Loan guarantees are the final kind of federal government involvement with credit for the housing market.<sup>222</sup> FHA mortgage insurance, begun in 1934, pledges the government to pay the lender if a borrower defaults. The VA mortgage guarantees program operates similarly.<sup>223</sup> The third major kind of loan guarantee program entails GNMA guarantees for mortgage-backed securities.<sup>224</sup> These guarantees pledge GNMA to take the loss if the mortgages "backing" the security should default.

The amounts of money involved in credit assistance for housing are huge. The government's contingent liability from the two major FHA programs alone has been estimated at over \$75 billion.<sup>225</sup> The total contingent liability outstanding for FHA insurance has been estimated at about

\$106 billion; for VA guarantees the estimate was about \$88 billion; for GNMA guarantees about \$65 billion.<sup>226</sup> FNMA and FHLMC grew from \$40 billion in 1973 to \$58 billion seven years later, an increase of 45%, due primarily to a steep increase in the activity of FHLMC (which represented 7% of all credit assistance for housing in 1973; 27% in 1977).<sup>227</sup>

Traditionally, credit programs have generally been thought of as "support" programs, costing little or nothing in the long run. The FHA insurance program, one "support" program, is designed so that the income received from fees and premiums normally covers program costs. FNMA and FHLMC also are designed to be self-supporting, although both receive substantial tax preferences. The VA mortgage guarantee program and GNMA both are not designed to be self-supporting, i.e. the income they receive does not cover program costs.

2. Failure of budget reformers to control and account for federal credit activity

The recommendations of the Report of the Commission on Budget Concepts regarding what the tax expenditures should be included in the Budget were implemented in 1968<sup>228</sup> and were incorporated into the Congressional Budget Act in 1974. The Commission's recommendations regarding credit, however, did not fare so well. Although its recommendation that direct loans should be counted as expenditures was

adopted, its recommendation that the subsidy elements should be calculated for all credit programs has been implemented only in a very few instances.<sup>229</sup> In addition, the Congressional Budget Act of 1974 did not provide for a separate accounting of credit activity, and exempted credit (other than direct-loan programs) from the budget process.<sup>230</sup> In the 1970s, a chapter discussing loan guarantees was introduced into the Special Analysis document that accompanies the budget, but accounting for credit disbursements before the 1981 Budget was in a very rudimentary state. The Comptroller General testified at one of two sets of the hearings held in 1976 and 1977:<sup>231</sup>

It is significant that almost no information is available regarding [the relationship between direct subsidies and credit policies....It] has not adequately been dealt with...either publicly or by the Congress. [The attention given to credit policies] is all out of proportion...in relation to [that given to]...appropriated funds in the budget....We believe that there should be full disclosure of the budget impact of existing and proposed Federal credit and credit support programs. Only if there is full disclosure through the budget process can the full impact of such programs and the tradeoff with other federal programs be evaluated.<sup>232</sup>

The Comptroller General might have added that tax expenditures also now receive far more public attention than do most credit policies. He did note that "almost no information is available" about the relationship among loan guarantees, direct loans and direct subsidies.<sup>233</sup>

The hearings documented the recent extremely rapid

growth of federal credit disbursements, which grew 162% in the decade from 1970-1980.<sup>234</sup> The hearings presumably were part of the momentum that led to President Carter's promise in the 1980 Budget to introduce credit controls as soon as possible.<sup>235</sup>

3. The accounting of credit programs and the system for control of credit expenditures in the 1981 Budget

The 1981 Budget introduces the first comprehensive accounting for credit activity. Since prior documentation of credit programs was ad hoc and incomplete,<sup>236</sup> the fact that an accounting is being provided for credit programs at all is a step forward. Just as the formal accounting of tax expenditures was the first step in the process of calling attention to the costs of tax expenditures, the accounting presented in the Budget is a first step in calling attention to the costs of credit programs.

The approach taken in the Budget is to record the net funds advanced in a given year, i.e. the difference between the amount of loans outstanding at the beginning and at the end of the year. The only form of credit subsidy calculated is interest subsidy that arises when the federal government gives credit directly at a lower interest rate than would be charged by private lenders.<sup>237</sup>

This method of accounting serves as the data base for the system of controls over credit activity instituted

in the 1981 Budget.<sup>238</sup> The system is aimed at controlling aggregate amounts of lending for both direct loan and loan guarantee programs by setting annual limitations on gross liability, in the form of binding limitations on individual programs proposed for inclusion in annual appropriations acts.<sup>239</sup>

The control system implemented in the Budget is conceded to be a limited one.<sup>240</sup> At present, all housing credit programs are exempted. At one point the reason given is the "current uncertainty in the housing market."<sup>241</sup> That is, the housing industry is excluded from credit limitations temporarily because it already is plagued by scarce and expensive credit. But a closer reading of the Budget reveals that some important housing programs are intended permanently to be exempted from the controls. Exemption for FHA loan guarantees and GNMA guarantees of mortgage-backed securities are intended to be temporary and will be re-evaluated in 1982.<sup>242</sup> However, the exemption of FNMA and FHLMC is permanent (at least in this "initial phase") because both are off-budget agencies and all off-budget agencies are excluded from the controls. The exemption of VA mortgage guarantees also is permanent, because a ceiling allegedly would be illegal since the VA gives a "clear and unqualified entitlement to the qualified applicant."<sup>243</sup>

4. Evaluation of the 1981 Budget's treatment of credit programs

The decision to provide a formal accounting of credit activity and to control credit outlays will help to remedy the tendency of tax- and budget-reformers to focus exclusively on tax expenditures and direct subsidies to the exclusion of credit programs. The proposed system is by no means perfect, however. Two criticisms are presented below.

Exemptions from credit controls. The programs exempted from the credit control system are exempted either directly or indirectly as a result of their political power. A recent article in the New York Times<sup>244</sup> linked the fact that a bill for a stronger credit control system introduced by Representative Norman Mineta had little chance of passage with the fact that the Administration this year explicitly exempted from its proposed credit controls the bulk of Government credits including "the politically powerful mortgage guarantees issued by the Federal Housing Administration and the Veterans' Administration, and the Government National Mortgage Association guarantees of mortgage-backed securities." The FHA and VA programs benefit, and therefore presumably gain political support from, the banking community and the middle class; GNMA mortgage<sup>guarantees</sup><sub>A</sub> go predominantly for lower-income housing, but also have powerful political allies in the banking community.

A number of reasons are given in the Budget for exempting

the various housing programs, but if these are examined closely it becomes apparent that they all tie back to the programs' political power. The VA is exempted because it had the political clout to obtain a clear and unambiguous entitlement<sup>245</sup> -- the kind of entitlement that has never been obtained in any housing program for the poor.<sup>246</sup> The Budget cites as the reason why FNMA and FHLMC are exempted the fact that both organizations are off-budget. But don't the programs succeed in staying off-budget largely because they have the political power to do so?<sup>247</sup>

The proposed system of credit controls is informed by political reality just as was the strategy of tax reformers. In each case, political considerations have yielded the same results: budget reform efforts are concentrated on purifying the programs for the poor, while challenges to the politically more powerful programs for the nonpoor are deferred indefinitely. We have seen this strategy at work in the tax expenditure context, as tax expenditure analysts ignore homeowner deductions to focus on purifying the shelters for low-income housing. It seems that credit control advocates are adopting the political strategy of challenging programs for the poor but not those for the nonpoor.

The decision to exempt all major housing programs for credit controls is an example of this political strategy.<sup>248</sup> The credit programs exempted are programs that traditionally have been the primary (non-tax) housing programs for the



nonpoor: the FHA and VA loan guarantee programs and FNMA and FHLMA secondary mortgage market operations. FHA traditionally has benefited the lower-middle class,<sup>249</sup> while VA has given its largest benefits to the middle class.<sup>250</sup> FNMA's activities, because it deals primarily in FHA and VA mortgages, also has given benefits primarily to the nonpoor. FHLMC, which handles only conventional house loans, presumably has benefited primarily the middle and upper-middle income people who have been able to afford the high prices of conventionally financed single-family houses during the period since FHLMC was founded in 1970.<sup>251</sup>

Even GNMA, in theory used to provide subsidies primarily to government subsidized housing, in fact channels a substantial proportion of its benefits to the nonpoor. HUD's 1977 accounting for special assistance functions shows that only 56% of GNMA's commitments since its founding in 1968 have gone to buy mortgages of low-income housing. (This proportion had been raised to 70% for 1977 expenditures considered alone.)<sup>252</sup>

Since housing credit programs benefit primarily the nonpoor, a strategy of budget analysis that keeps sharp controls on direct subsidies and tax expenditures -- the two funding formats used predominantly in programs for the poor<sup>253</sup> -- while not challenging credit programs or those tax expenditures that benefit the nonpoor, ultimately will help skew the distribution of housing benefits more and more towards the nonpoor. This basic conclusion will hold even if FHA and

GNMA guarantees are included in the credit control system by the early 1980s. For the FHA and GNMA guarantees are the least regressive of the major credit programs. Controls over FHA mortgage insurance will affect, in addition to the bulk of lower-middle class FHA beneficiaries, the programs which ensure the mortgages of Section 8 projects for lower-income people.

Meanwhile, no controls are planned for FNMA or FHLMC. Yet it is these secondary mortgage market programs that are growing. The heyday of FHA and VA, when 30% to 50% of the housing starts each year were built under the two programs,<sup>254</sup> is past. Recently the proportion of FHA and VA loans has fallen to about 6% of all housing loans.<sup>255</sup> By contrast, credit activity of FNMA and FHLMC has boomed. This is particularly true of FHLMC, which deals only with conventionally financed (i.e. fairly expensive) homes. FHLMC's expenditures grew in the four years from 1973 and 1977 from 7% to 27% of total government credit assistance for housing.<sup>256</sup> Moreover, its portfolio grows at a rate of about 30%/year, whereas FNMA's portfolio, composed largely of lower-priced FHA and VA mortgages, is growing at roughly 5%/year.<sup>257</sup>

In conclusion, an analysis of the credit control system proposed in the 1981 Budget suggests that budget reformers (like tax reformers before them) propose to focus their efforts on purifying politically more vulnerable programs that happen to benefit the poor, while ignoring programs that are less

vulnerable politically because they benefit primarily the nonpoor. The regressive implications of this choice should not be overlooked.

Failure to calculate subsidies implicit in credit activity.

The accounting system introduced in the 1981 Budget calculates the net amounts of credit given annually. It does not, except in a small minority of cases, provide any calculations of the amounts of subsidy implicit in credit programs. Yet such figures are vital if credit programs are to be compared with tax expenditure and direct subsidy approaches, for without calculations of the subsidy element of credit activities, it is impossible to evaluate the cost efficiency of credit programs.

Calculations of the net amounts of credit given annually are useful in determining the effects of federal credit programs on the economy as a whole. These macroeconomic impacts can be important considerations in the design and evaluation of credit programs. In 1968, for example, there was virtually full employment as well as substantial inflation. The Office of Management and Budget decided that, under these conditions, FNMA by buying up mortgages was in effect increasing government expenditures just as if the federal government had issued new dollar bills and spent them as direct subsidies.<sup>258</sup> Although this is now considered to have been an overreaction, the secondary mortgage does under certain economic conditions impact the economy with substantial costs.

More recently it has been suggested that federal credit activity has contributed to declines in economic growth and to inflation. Economists have argued that loan guarantees tend

to allocate resources to politically influential borrowers rather than to investments that might be more productive economically. Representative Norman Minetta noted the relationship between loan guarantee programs and inflation:

We have credit programs offering loans at 7, 6 and 2 percent,....On the one hand we're trying to slow money growth to stop inflation while on the other hand we're handing out Federal loans at interest rates below what it costs the Treasury to borrow the money from the public.<sup>259</sup>

The proposed credit accounting system based on net annual credit activity is useful in determining the macroeconomic impacts of credit programs. However, an important drawback is its failure to disclose the amounts of subsidy hidden in the various credit programs.<sup>260</sup> Calculations of subsidy are vital, 1) if credit programs are to be compared with alternative direct subsidy and tax expenditure approaches, 2) if the cost efficiency of credit programs is to be evaluated, and 3) if a full accounting is to be provided that affords a way of measuring annual expenditures. The President's Commission on Budget Concepts recommended that subsidies associated with credit programs is calculated in the Budget, but the recommendation was not carried out.<sup>261</sup> The only calculations I could find of subsidies entailed in housing credit programs are those in Henry Aaron's Shelter and Subsidies published in 1972.<sup>262</sup>

Considerable attention has been focused recently on how to calculate the amounts of subsidy involved in loan

guarantee programs. An official from the General Accounting Office explained the general principle in the recent hearings:

The degree of subsidy and the cost to the Government in a loan guarantee program both depend on the underlying risks and upon such features of the guarantee as the fee to be charged, the fraction of the loan to be guaranteed, the extent of recourse to assets of the borrowers, and other features of the agreement.

These features can be set to achieve almost any desired degree of subsidy, which at the same time will determine the cost to the Government.<sup>263</sup>

In other words, the level of subsidy involved in a loan guarantee program depends on the risks involved and on the degree to which recipients pay to help cover those costs.

Even when a loan guarantee (such as the FHA mortgage insurance program) is designed so that income is supposed to cover costs, its long-term financial self-sufficiency depends upon the rate of defaults, which in turn depends upon market and economic conditions. If conditions differ substantially from those predicted, therefore, the FHA could entail substantial subsidies.<sup>264</sup>

Programs not designed to be self-sufficient can entail very substantial subsidies. Again, the amount of subsidy is determined by the extent to which income from fees and premiums covers expected outlays. VA mortgage guarantees have been subsidized throughout their existence.<sup>265</sup> The amount of risk entailed is what ultimately determines the price of a loan guarantee program. At one extreme, the

standard FHA mortgage insurance program involves relatively small risks (and, therefore, minimal outlays) under normal economic conditions. At the other extreme, public housing involves very high risks, and, therefore, very high potential costs. In the recent hearings the GAO testified that it is unlikely that public housing projects will generate sufficient revenues to service any of their bond debt. Under these high-risk circumstances, the cost of loan guarantees can equal or exceed the cost of an equivalent direct subsidy, since government probably will have to pay off all interest and principal on the \$14 billion of public housing bond guarantees.<sup>266</sup>

Mortgage insurance for other low-income housing programs also can be expected to entail high costs. Since fully one-fourth<sup>267</sup> of Section 236 projects have defaulted, the spectre exists that Section 236 -- and, presumably, Section 8 projects as well -- may involve huge hidden costs. This prospect becomes more likely when one projects the cash flow of a typical Section 8 project in 10 - 20 years. By that time, the tax shelter will have been used up. Since cash flow from many if not most Section 8 projects will not be large, investors will simply be waiting to sell off at a time that minimizes recapture. Once the minimum number of months required to avoid recapture has passed, holding onto the project will only decrease the rate of return.<sup>268</sup> One of several scenarios is possible. If a healthy market for

for apartments exists, the project owners could sell to someone who wanted to put the building on the market at market rents. This is commonly thought to be what will happen to many if not most Section 8 elderly projects. Alternatively, the new owner could keep the Section 8 subsidy arrangement (along with Section 8 tenants) -- this would offer greater cash-flow security, especially if the building was in a neighborhood that precluded market-rate rents. Finally -- and this would be an attractive alternative to owners of a project for which no buyers could be found -- the owner could default. This would trigger recapture just as would a sale,<sup>269</sup> so that the owners could get out of the project on schedule and preserve their rate of return. It would also mean that the costs of the FHA loan guarantees on Section 8 projects would turn out to be much longer than originally anticipated.

In conclusion, a system of credit accounting that documents only net amounts of credit is useful for measuring the macroeconomic impacts of credit programs. In order to compare the costs of credit programs with those of tax-expenditure and direct-subsidy alternatives, however, the amount of subsidy hidden in credit programs also must be calculated.

##### 5. Credit programs, tax expenditure analysis and housing policy reform

The 1981 Budget has made an important first step in

focusing attention on credit programs. No full accounting of federal housing expenditures can ignore the costs associated with credit programs; tax expenditure analysis does so by focusing on direct subsidies and tax expenditures exclusively. Credit policies should not be overlooked for three reasons. First, once the costs of credit programs (particularly loan guarantee programs) are added into the other costs of the present pattern of low-income housing expenditures, it might well become clear that a production subsidy approach to low-income housing involves impossibly high costs /unit. Second, once the costs of credit programs are added to the costs of direct-subsidy and tax-expenditure programs, the striking regressivity of housing programs may well become even more pronounced, since credit programs (now counted as free) benefit predimnantly the nonpoor.

Finally, analysis of credit programs should be integrated with analyais of tax-expenditure and direct-subsidy programs because credit programs have peculiar characteristics with important program design implications that should be considered in a comprehensive restructuring of housing programs.

At the recent hearings, a Treasury Departmen official noted three disadvantages of loan guarantees relative to other forms of federal assistance.<sup>270</sup> In addition to being a "shotgun approach to risk" -- i.e. like tax expenditures, difficult to target on a precisely defined group -- the



official noted that loan guarantees can entail potential losses greater than either direct capital grants or tax expenditures. The potential loss from loan guarantees includes not only the principal amount but also the interest owed on the loan. Moreover, the bureaucratic and political embarrassment that results from defaults means that wasted support may often be funneled into hopeless projects to avoid default at any cost. Finally, particularly when loan guarantees are linked with tax incentives, they may encourage private developers to undertake uneconomic projects for tax reasons, and then default. Any attempt to restructure housing programs that concentrates on tax expenditures and direct subsidies exclusively (as does tax expenditure analysis) would fail to consider any of these three factors in its proposed restructuring of housing programs.

B. Direct subsidies as backdoor expenditures

Tax expenditure analysis' assumption that all direct subsidies are visible, accountable and controllable is incorrect. In fact, direct expenditures for housing have normally been structured to hide the type and level of financial commitment being made. This pattern began with public housing, a program usually thought of as the epitome of a direct, front-door approach to governmental provision of housing.

The public housing program, when it was introduced

in 1937, offered two alternative ways for localities to cover debt service on the project mortgage.<sup>271</sup> The first was a straightforward system of capital grants made by the federal government to the local housing authority (LHA). This system, however, was a dead letter. All projects used the alternative method offered, whereby the federal government and the LHA agreed on a "contract" that committed the federal government to make uniform yearly payments to the LHA for a term of up to 60 years. Since the "annual contribution" was set at an amount covering debt service, the methods were the same from the viewpoint of the LHA. But from the federal government's point of view, the methods differed in one very important respect. To the extent that capital grants were given, the entire cost of the housing project would count as a current federal expenditure in the year of construction. For this reason the capital grants were not popular with federal officials, who preferred to have only the (much smaller) annual debt service reflected in the annual budget.

The system of annual contributions was somewhat extraordinary in that it assumed to bind the federal government to a series of long-term contracts. Politically, it was a useful way of organizing a housing program. It called for relatively small annual appropriations; this made the passage of the (public housing) bill more palatable to fiscal conservatives. Had outright capital grants been made, huge sums of money would have been necessary at the outset. As it was, the government bought public housing on the installment plan.<sup>272</sup>

If the method chosen to finance public housing was "backdoor," at least the amounts needed each year during the repayment term were set from the start. Such was not the case when the basic approach developed in the public housing context was adapted first for the Great Society programs (Sections 235 and 236) and then for Section 8.

The Great Society programs committed the government to pay the difference between the amounts paid by program beneficiaries<sup>273</sup> and the amount needed to cover the actual debt service at market rates charged by the bank. Of course, the amount of the subsidy/unit grew as interest rates rose. When the programs were enacted in 1968, with interest rates about 6.5%, the maximum subsidy for Section 235 and Section 236 were 50% and 35% of mortgage payments respectively. By 1970, with interest rates on FHA mortgages at 8.5%, maximum subsidy level had risen to 60% for Section 235 and 44% for Section 236.<sup>274</sup>

In Section 8 the level of subsidy needed per unit was tied to a factor even more volatile than interest rates: rents. A Section 8 commitment is a promise to pay a developer the difference between that amount of the rent roll paid by eligible low-income tenants (equal to about 25% of their incomes) and the market rental of the projects.<sup>275</sup> Thus the amount of subsidy required per unit rises automatically if the rate of growth in the incomes of low-income people does not match the rate of growth of market rents. This, of course,

is what has happened. As a result, if rents and incomes increase in the future at the same rates as in the past, Section 8 subsidy commitments "will turn out to be seriously underfunded," according to an 1978 CBO study.<sup>276</sup> This is so because budget authority for Section 8 is based on the maximum allowable rent for the first year times the term of the commitment. If rents rise faster than do tenant incomes, therefore, the amount of subsidy required per unit rises automatically.<sup>277</sup>

The 1981 Budget acknowledges the impact of structuring direct subsidies as were the subsidies to public housing, Section 236 and Section 8. The Budget calls such outlays "uncontrollable,"<sup>278</sup> and notes that fixed costs and open-ended programs (of which housing assistance programs are an example)<sup>279</sup> have been growing at such a rapid rate that the proportion of government expenditures rated as uncontrollable has been rising very rapidly:

As recently as 1967, open-ended programs and fixed costs accounted for only 36% of total outlays. By 1973 they were more than 50% of the budget and in 1981 the are estimated to be 59%.<sup>280</sup>

Once these costs are added to costs uncontrollable because they represent prior-year contracts, about three-fourths of all outlays in the 1981 Budget are uncontrollable.<sup>281</sup>

In summary, the tax reformers' view that direct subsidies are per se desirable must be reconsidered once the primary concern has shifted from tax to budget reform.

Many direct subsidies do not meet budget reform goals because 1) they are not readily visible and therefore are not accountable expenditures, and 2) even to the extent that they are accountable, they are impossible to control (at least in the short term ). Budget reformers must therefore stop equating the issue of funding format with budgetary goals. Budgetary reformers' goal should be to structure expenditures to maximize visibility, accountability, and controllability of expenditures regardless of whether the funding format chosen involves direct subsidies, tax expenditures, or credit activity.

C. Backdoor financing as a by-product of the passive intervention strategy

Once tax expenditure analysis is assimilated into the broader perspective of "backdoor financing," a striking tendency becomes apparent for all housing programs (for the nonpoor as well as the poor) to be financed circuitously. To be sure, distinctions must be drawn between programs such as VA mortgage guarantees or public housing and the heights of Byzantine complexity achieved in the contemporary Section 8 projects. Yet before an attempt is made to change the backdoor financing piece by piece, it is worthwhile stopping to analyze the forces that have driven American housing programs so consistently to "backdoor" approaches, in contrast (for example) to the straightforward approach implemented in the

national highway program.<sup>282</sup>

1. Backdoor financing as an American way of life

Contrary to reputation, the United States government in the early 19th century was very much involved in economic development.

[It] was a period of promotion of enterprise, of the release of creative energy: government, reflecting its powerful constituencies, wanted business and the economy to grow....There was a public right -- a public duty -- to lend a hand to productivity. This meant that government must provide public goods, especially transportation.<sup>283</sup>

Grants to private actors for the construction of turnpikes and canals were common.

Much of the work of the legislatures, in the first half of the 19th century, consisted of chartering transport companies, and amending their charters....Chartering, however, was only a small aspect of government participation. The states and cities played a more critical role: they supported, by money and credit, internal improvements; and some they constructed themselves.<sup>284</sup>

New York State built the Erie Canal, at a cost of over \$7 million.<sup>285</sup> Ohio, in 1837, passed a law promising matching funds for any internal improvement company (railroad, turnpike or canal) that met certain standards.<sup>286</sup> No self-consciousness existed about giving direct grants to private actors (or about government itself replacing private actors altogether), since in pre-Civil War America the firm distinction between public and private that came to dominate

political thought by the late 19th century was still unimportant.<sup>287</sup> If most of the governmental aid was not in the form of direct grants<sup>288</sup> this was because the government simply did not have that much cash to spend. A huge Revolutionary War debt combined with an embryonic tax structure to limit direct forms of governmental generosity and enterprise. Consequently, much governmental aid<sup>289</sup> was in the form of land grants, monopolies ("charters"), or property tax forgiveness.

After the Civil War, when attention turned from turnpikes and canals to railroads, the government continued to encourage economic growth. Increasingly, however, a complication entered in. The meteoric rise of the distinction between public and private,<sup>290</sup> along with the concomitant conviction that governmental intervention in the economic sphere would produce disastrous results,<sup>291</sup> made it ideologically awkward for the government to be involved directly in economic development. In addition to potential ideological objections, the tax structure still raised relatively small amounts of money.

For this combination of ideological and practical reasons, governmental programs after the Civil War switched from "active" to "passive intervention." Rather than building the desired railroads itself, the government merely gave subsidies to the private sector to enable private actors to build. Backdoor subsidies avoided the awkward mixing of public and private actors to build a transportation network privately

owned and operated for profit. Entrepreneurs were not so ideological as to reject economic benefits, but governmental participation was designed clearly to signal that the government was not buying a participant's (or an owner's) right to take part in the control of the enterprise.<sup>292</sup> Forms of backdoor financing included extensive land grants given to railroads by the federal government; local government forgave property taxes and allowed promoters to finance their schemes with local bond issues.<sup>293</sup>

## 2. Backdoor financing in housing policy

The same combination of ideological and practical advantages has made backdoor financing a frequent approach throughout the history of American housing policy, because the building of housing involves some of the same ideological and practical problems involved in building the transportation infrastructure in the 19th century.

The first practical consideration was that housing, like the canals and railroads of an earlier era, is a capital good. Since capital goods are very expensive, a very large (and therefore potentially very visible) outlay was required. This situation has not always led to the use backdoor financing in American domestic policy: the interstate freeway system and the space program both involved huge outlays for capital goods in the form of direct subsidies "up-front." But there is a crucial difference between these programs and the building of



housing, turnpikes, canals or railroads. The freeway system and the space program involve "public goods," in the economist's sense of the term.<sup>294</sup> Housing -- even public housing -- clearly is the opposite of a public good: it is quintessentially private. The canals, turnpikes and railroads of the 19th century seem at first to be public goods, since a publicly owned transportation system (such as freeways) is a public good. But in important ways these earlier transportation systems were not public. They were private businesses operated for profit, and hence were no more public than a supermarket.

Backdoor financing has obvious advantages when government funds are used to support construction of a nonpublic capital good, because this situation involves a violation of the ideological distinction between public and private and, since large amounts of money are involved, the violation is hard to overlook. Backdoor financing eases this dilemma by disguising the nature and the value of the governmental aid. Moreover, since capital goods are involved, the use of backdoor methods can be justified on other than purely political grounds. For even in the private sector (which in the U.S. is the norm), construction of capital goods often involves complex financial structures in which funds are difficult to trace. Backdoor financing can be defended on the ground that it simply emulates the private sector by creating financial structures of similar complexity. (The rationale behind

the complex financial arrangements, of course, is that since a capital good lasts a long time, it should be paid for over a long period, rather than incurring the entire cost "up-front.")

The ideological distinction between public and private makes a passive intervention strategy supported by backdoor financing attractive for another reason. One of the central tenets of the ideology of public and private is that "the market" can achieve a given production goal with optimal efficiency. In recent times this traditional economic argument has merged with the "interest group" analysis of American politics to produce a new version of the traditional rationale for a passive intervention strategy. Not only is "working through the market" inherently more efficient than is direct governmental intervention (the argument goes); it also offers political advantages, since accommodation of private interest groups means that one gains their political support. In either version of the argument, the fact that "incentives" give the government little control over the ultimate product is considered desirable because the "discipline" of the market system is thereby left as nearly intact as possible.

This second argument about the economic and political advantages of a passive intervention strategy has been particularly important since 1968, when housing policy analysts reached the conclusion that public housing was "such a failure" whereas the FHA and VA programs were "such a success"

because the latter worked through the market, preserving private incentives, whereas the former did not, depending instead on direct governmental intervention. The desire to garner political support for low-income housing from the private actors who would receive the incentives lurked not far behind the economic argument that the private market would be more efficient in producing low-income housing than would the government.<sup>295</sup>

Once the focus is shifted from tax expenditures onto all forms of backdoor spending, the limitations of tax expenditure analysis become obvious. If tax expenditures are viewed as only one form of backdoor spending,<sup>296</sup> it is clear that analysis of tax expenditures must be augmented with analysis of other funding formats--of credit activities and "uncontrollable" direct subsidies. From this new perspective, backdoor spending can be placed in historical perspective, and the reasons for its persistence in American history can be analyzed.

## Conclusion

There are two major points.

The first involves a critique of tax expenditure analysis' traditional focus on translating tax expenditures into direct subsidies.<sup>297</sup> Figure 6 shows that existing housing programs both for the poor and the nonpoor utilize not only tax expenditures and direct subsidies, but also credit policies. As we have seen, all three types of funding formats can be cost-inefficient and can lack visibility and controllability. Therefore, once the narrow focus on tax reform is replaced by a more ambitious attempt to restructure housing programs to achieve housing-policy goals, tax-reform goals, and the budgetary goals of cost-efficiency, visibility and controllability of expenditures, traditional tax expenditure analysis must be replaced with a broader analysis of the interaction between funding format and those housing, tax and budgetary goals.<sup>298</sup>

The second major point concerns the political strategy used by tax-expenditure analysts, first in the tax- and now in the budget-reform context. Tax- and budget-reformers naturally have chosen to focus their attacks on programs they thought they could change. Unfortunately, since housing programs that benefit the poor have far less solid political support than do housing programs that benefit the middle class and the rich, first the tax- and then the budget-reformers

Figure 6: Funding format of housing expenditures

Housing expenditures for the nonpoor

Tax expenditures: homeowner deductions  
capital gains deferral on sale of  
principal residence  
bad debt reserve  
tax shelters (for luxury apartments  
and nonresidential)  
FNMA & FHLMC tax preferences

Credit: FHA mortgage insurance  
VA mortgage guarantees  
VA low-interest loans  
GNMA credit activity (tandem plan)  
FNMA credit activity  
FHLMC credit activity

Direct subsidies: CDBG rehabilitation funds  
Section 312 rehabilitation funds  
Section 236  
Section 235 (revised)  
Section 202 housing for the elderly  
and handicapped

Housing expenditures for the poor

Tax expenditures: local housing authority bonds  
state housing finance agency bonds  
tax shelters (includes Sect. 167(k))

Credit: FHA loans and guarantees  
Rural Housing Insurance Fund  
GNMA subsidies  
GNMA credit activity

Direct subsidies: public housing (annual contributions  
and operating subsidies)  
Section 8 rent supplements  
Section 235 (original)  
Section 202 housing for the elderly  
and handicapped  
Section 312 rehabilitation  
CDBG rehabilitation funds

Sources: CBO, Real Estate Tax Shelter Subsidies and Direct  
Subsidy Alternatives, pp. 40-4; Senate Budget Comm.,  
Tax Expenditures (Comm. Print. Sept. 1978).

have focused attacks on programs benefiting the poor (e.g. low-income housing tax shelters) while leaving alone those programs that predominantly benefit the nonpoor (e.g. homeowner deductions and housing credit programs).

The focus of tax- and budget-reformers on programs for the poor is intended to be temporary.<sup>299</sup> Yet, the fact that backdoor expenditures have been so persistent throughout American history raises questions about whether backdoor spending ever can be eliminated entirely, since backdoor spending plays a useful role by blunting the contradiction between the fact that Americans want to utilize passive intervention programs despite the taboo against mixing public and private by giving public money ("incentives") to private actors. If backdoor spending never will be eliminated entirely, any success of tax- and budget-reformers in translating housing programs for the poor into subsidies that are visible and accountable may well have serious regressive effects if housing subsidies for the nonpoor continue involve backdoor funding. For then, housing expenditures for the poor will be very visible to voters, whereas housing expenditures for the nonpoor will be largely unrecognized. This is the situation that existed during the 30 years of public housing,<sup>300</sup> and the result, presumably, would be similar: increased political vulnerability of housing programs for the poor linked with relative political

invulnerability of housing programs for the nonpoor. The regressive implications of the political strategy of tax- and budget-reformers should be recognized.

FOOTNOTES

1. See S. Surrey, The United States Income Tax System--  
The Need for a Full Accounting (November 15, 1970),  
reprinted in W. HELLMUTH & O. OLDMAN, TAX POLICY AND TAX  
REFORM: 1961-1969, 575-86 (1973) (hereinafter cited as  
HELLMUTH).
2. Act of July 12, 1974, Pub. L. 93-344, 88 Stat. 297 (codi-  
fied in scattered sections of 1, 2, 31 U.S.C.).
3. CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER  
SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES xiii (1977)  
(hereinafter cited as CBO study).
4. See text of notes 116-181 infra.
5. See text of notes 182-246 infra.
6. A very rough approximation of the distribution of  
housing subsidies between the poor and the nonpoor  
follows.

		(in	
Subsidies for nonpoor (in billions)		Subsidies for poor***billions)	
\$14.8	mortgage interest deduction**	\$1.17	public housing
9.0	property tax deduction**	.89	Section 8
1.1	tax deferral on home sales**	.55	Section 236
1.0	bad debt reserves for banks**	.262	rent supplement
1.3	estimated subsidies (FHA, VA, ***	.028	GNMA Tandem
	Farmer's Home Admin.,* GNMA		(multi-family)
	Tandem Plan, revised Sect. 235)	.290	FHA (multi-family)
\$27.2	billion	.086	FMHA (multi-family)
		.738	Section 202
27.2		.120	Tax shelter for low-
31.3	= 87% of total subsidies for		income housing
	nonpoor	\$4.134	billion

\* credit activity is excluded

\*\* Source: FY 1981 BUDGET

\*\*\* Source: CBO STUDY.

N.B. Some figures are for 1981 while others are for 1978 because the CBO study's 1978 figures provide rare calculations 1) of the allocation between poor and nonpoor of programs such as the GNMA Tandem Plan, and 2) of the amounts of subsidy entailed in FHA, VA and FMHA. However, use of the 1978 figure somewhat underestimates the expenditures for lower-income housing. Since the goal is merely to compare orders of magnitude, this is not viewed as a serious deficiency. Nonetheless, the 87% is reduced to 80% to counteract this distortion.



- 6a. Act of Dec. 30, 1909, Pub. L. 95-172, 83 Stat. 487, Titles 1-9.
7. See text at notes 217-296 infra.
8. See text at notes 217-18 infra for a full description of how this term is used. In general, it refers to any type of expenditure that does not go through the normal yearly appropriation process.
9. For examples of this very common claim, see S. SURREY, PATHWAYS TO TAX REFORM 236-7 passim (1973) (hereinafter cited as PATHWAYS) ("the tax system blundered into its present tax expenditure assistance for rental housing..."). An alternative claim is that tax expenditures, far from being "inadvertent," result from the power of special interest lobbyists. See RUSKAY, HALFWAY TO TAX REFORM 208-218 (1970) (hereinafter cited as RUSKAY).
10. See G. NIKOLAIEFF, TAXATION AND THE ECONOMY 1-24 passim (1968) (hereinafter cited as NIKOLAIEFF) for an example of the "euphoria" over "the longest boom in history" (at 1) and the conviction that proper application of Keynesian principles would ensure future economic growth.
11. One early important expression of the American rediscovery of poverty in the 1960s is M. HARRINGTON, THE OTHER AMERICA (1962).
12. R. WAGNER, R. FREEMAN, C. McLURE, N. TURE & E. SCHIFF, PERSPECTIVES ON TAX REFORM 77 (1976) (hereinafter cited as WAGNER).
13. See NIKOLAIEFF, supra note 10, at 1-41 for the importance of Keynesian macroeconomics in the post-war period.
14. See generally, NIKOLAIEFF, supra note 10. Surrey's speeches given in the early 1960s while he was Assistant of the Treasury also illustrate the focus on economic growth. S. Surrey, Tax Policy and Economic Growth (March 12, 1962) (hereinafter cited as Tax Policy and Economic Growth); The Current Tax Scene (March 23, 1966); Federal Tax Policy in the 1960s (April 21, 1966); Current Tax Developments (August 6, 1966) (available in bound form at the Harvard Law School Library).
15. See Tax Policy and Economic Growth, which discusses the investment tax credit, the best example of the way in which the concern with economic growth was translated into a concern for capital formation.

16. INT. REV. CODE of 1954 Section 167 (1954) (amended repeatedly).
17. TAX FOUNDATION, DEPRECIATION ALLOWANCES 20 (1970).
18. INT. REV. CODE of 1954 Section 167(c) (1954) (amended repeatedly).
19. INT. REV. CODE of 1954 Section 167(c) (1954) (amended 1969). What in fact happened was that the 1954 Code increased the maximum depreciation rate to 200% for new buildings, while the older 150% rate that had been allowed administratively continued to be used for existing buildings. See H.R. REP. NO. 1337, 83 D Cong. 2d. Sess. 23-5 (1954).
20. Neither the practice of avoiding tax through use of the installment sales provision, INT. REV. CODE of 1954 Section 453 now the "like-kind exchange," INT. REV. CODE of 1954 Section 1031 are discussed here. Neither are the one-time exclusion of proceeds from the sale of a single-family house. INT. REV. CODE of 1954 Section 1038(a), nor the practice of allowing banks a bad debt reserve in excess of actual defaults, INT. REV. CODE of 1954 Section 585.
21. INT. REV. CODE of 1954 Section 266; Treas. Reg. Sec. 1.266-1 (1959) (amended 1976).
22. In fact, the 1942 tax code provided that a taxpayer could elect either to deduct or capitalize construction expenses. Most developers choose to deduct because of the economic benefits available from tax deferral. See J. McCOY, H. OLSEN, C. REED, R. SANDISON & R. WRIGHT, FEDERAL TAXES AFFECTING REAL ESTATE 74 (1970) (hereinafter cited as McCOY).
23. H. AARON, SHELTER AND SUBSIDIES 62 (1972) (hereinafter cited as AARON), quoted in PATHWAYS, supra at note 9, at 233.
24. STAFF OF SENATE COMM. ON BUDGET, 95TH CONG. 2D SESS., TAX EXPENDITURES 69 (Comm. Print Sept. 1978) (hereinafter cited as SENATE BUDGET COMMITTEE REPORT).
25. INT. REV. CODE of 1954 Section 1034.
26. The provision is allowed only when a taxpayer sells his "principal residence." I.R.C. Section 1034.

27. See e.g. PATHWAYS, supra note 9, at 236-7 and passim; see generally SENATE BUDGET COMMITTEE REPORT, supra note 24.
28. See e.g. PATHWAYS, supra at note 9, at footnotes 116-117 to Chapter VII.
29. See PATHWAYS, supra note 9, at 1.
30. See HELLMUTH, supra note 1, at 579.
31. Id., at 580.
32. Id., at 582-3.
33. PATHWAYS, supra note 9, at viii.
34. WAGNER, supra note 12, at 79.
35. Id., at 81.
36. Act of Dec. 30, 1969, Pub. L. 91-172, 83 Stat. 487.
37. See M. Weidenbaum, The Case for Tax Loopholes in D. SKADDEN, A NEW TAX STRUCTURE FOR THE UNITED STATES 25 (1978), for a recent restatement of the capital formation rationale for regressive tax expenditures.  
The special treatment of the major tax expenditures received by upper-income tax payers and corporations--capital gains, the investment credit, and similar items -- is justified by the need to promote investment and achieve a growing economy, which will provide both more employment and a rising standard of living for the public as a whole.  
The pervasiveness of this attitude is indicated by the fact that it showed up in housing as well as tax policy. In housing policy it was expressed by the "filtering" theory -- that the government should concentrate on having programs for the nonpoor because then their old housing would "filter" down to the poor.
38. RUSKAY, supra note 9, at 174.
39. PATHWAYS, supra note 9, at viii.
40. See Tax Policy and Economic Growth, supra at 14:  
"Investment in machinery and equipment in this country during the decade of the 1950's was equal to about 6% of gross national product.... In West Germany, it exceeded 11%; in Italy and France, upwards of 8%."

41. See PATHWAYS, supra note 9, at viii.
42. HELLMUTH, supra note 1, at 578-579.
43. Surrey's earliest (c. 1968) and his most recent (c. 1979) protests that his tax expenditure analysis is objective are most convincing. Recent examples appear in S. Surrey & P. McDaniel, The Tax Expenditure Concept and the Budget Reform Act of 1974, 42 B.C. INDUS. and COM. L. REV. 685 (note 22) (1976) (hereinafter cited as B.C.L. REV. 1976), and S. Surrey and P. McDaniel, The Tax Expenditure Concept: Current Developments and Emerging Issues, 20 B.C.L. REV. 288 (note 165) (1979) (hereinafter cited as B.C.L. REV. 1979).
44. PATHWAYS, supra note 9, at 31. Surrey is explicit about the fact that this goal involves eliminating tax expenditures in Surrey, The Federal Legislature Process (April 28, 1976) 26 (1976) (hereinafter cited as Fed. Legis. Process): "(T)he issues of tax reform...charted in the 1960's...relate to horizontal equity, elimination of tax preferences and tax shelters, and ending escapes from tax."
45. Deductions give higher benefits to wealthy taxpayers because a \$1000 deduction reduces the tax dues from a taxpayer in the 70% tax bracket by \$700, whereas it reduces a 20% taxpayer's tax only \$200, hence it is "worth more" the higher one's tax bracket, i.e. the higher one's income.
46. If a taxpayer owes \$500 in tax, a \$1000 credit is worth only \$500 to him, whereas it is worth \$1000 to a wealthier taxpayer.
47. Depreciation deductions, deduction of construction period interest and taxes, homeowner deductions.
48. See generally, PATHWAYS, supra note 9. Despite Surrey's protests of objectivity, his discussion at 129 et seq. shows that he thinks tax expenditures should be translated into direct expenditures if they are not eliminated entirely.
49. PATHWAYS, supra note 9, at 204.
50. Id., at 32.
51. HELLMUTH, supra note 1, at 634.
52. The second argument is a strong expenditure reform concern. This kind of concern over the way the tax expenditure funding format affects the ability of an expenditure program to achieve its goals is the element

of tax expenditure analysis currently being developed.  
See generally, B.C.L. REV. 1979, supra note 43; See also  
footnote 102 infra.

53. Until fairly recently, the assumption was that new housing was preferable to old. This assumption is illustrated in HAAR, FEDERAL CREDIT AND PRIVATE HOUSING (1960) (hereinafter cited as HAAR) which documents the fact that improving housing quality throughout the 1950's was addressed primarily by construction of new single homes.
54. INT. REV. CODE of 1954 Sec. 167(c) (1969) (amended in 1976).
55. INT. REV. CODE of 1954 Sec. 167(j) (1969) (amended in 1976).
56. INT. REV. CODE of 1954 Sec. 167(j)(5) (1969) (amended in 1976).
57. INT. REV. CODE of 1954 Sec. 167(j)(4) (1969) (amended in 1976).
58. Crane and Commissioner of Internal Revenue, 331 U.S.1 (1947).
59. Each year for 10 years, taxpayer takes \$100,000 of depreciation deductions each year: he has therefore taken \$1,000,000 of deductions. For a 70% taxpayer, a \$1 deduction excuses him from paying 70¢ tax. Therefore, \$1 million in deductions are equivalent to \$700,000 "earned," i.e. that would have been paid in taxes but for the depreciation deductions.
60. INT. REV. CODE of 1954 Sec. 1202.
61. I have not incorporated the concept of present value into this or subsequent discussion in the interest of simplicity.
62. See RUSKAY, supra note 9, at 175.
63. INT. REV. CODE of 1954 Sec. 1250 (1969) (amended 1976).
64. This return is much lower than the norm, because I have concentrated on simplifying the example, rather than on maximizing the rate of return by juggling the depreciation rate, period held, and amount of equity invested.  
The taxpayer earns \$420,000 because:
  - a) his depreciation deductions saved him \$700,000 in taxes;
  - b) but the capital gains tax he had to pay when he sold the building was \$280,000;
  - c) \$700,000 - \$280,000 = \$420,000;
  - d) (This example does not take recapture into account.).
65. Quoted in RUSKAY, supra note 9, at 176. A figure of \$930 million is quoted in HELLMUTH, supra note 1, at 626. (No date is given for either estimate.)

66. Quoted in AARON, supra note 23, at 55 (from 1966 data); Surrey in 1973 quotes the figure of \$4.7 billion. PATHWAYS, supra note 22, at 234.
67. SENATE BUDGET COMMITTEE REPORT, supra note 24, at 70. Surrey himself opposed the homeowner deductions in PATHWAYS, while noting that "Congressional attitudes towards home ownership (made) it unlikely the provisions would be abolished in the absence of a substitute program." PATHWAYS, supra note 9, at 236. See text at notes 182-216 below for an evaluation of homeowner deductions today.
68. In contrast to another counterattack on Surrey's theory by Boris Bittker, who attacked Surrey's premise that "loopholes" entailed expenditures. See e.g., Bittker, The Tax Expenditure Budget--A Reply to Professors Surrey & Hellmuth, 22 NATL. TAX J. 538, 542 (1969).
69. Both points were made during hearings in 1967. See generally, Tax Incentives to Encourage Housing in Urban Policy Areas: Hearings on S. 2100 Before the Committee on Finance of the Senate, 90th Cong., 1st & 2nd Sess. (1967) (hereinafter cited as S.2100 Hearings).
70. See text at note 136-167 infra.
71. S.2100 was introduced by Robert Kennedy. See S.2100 Hearings.
72. U.S. PRESIDENT'S COMMITTEE ON URBAN HOUSING, A DECENT HOME (1969).
73. Act of July 5, 1968, Pub. L. No. 90-375 Sec.1(5); 82 Stat. 284 (1968).
74. Although in theory a developer needed to contribute 10%, the allowance of "builder's and sponsor's profit" (BSPRA) brought the effective percentage down to 1%. See J. KRASNOWIESKI, HOUSING AND URBAN DEVELOPMENT 262 (1969) (hereinafter cited as KRASNOWIESKI).
75. The legal structure involved is a limited partnership, with the developers as general partners and the "passive investors" as limited partners.
76. INT. REV. CODE of 1954 Sec.167(k). Section 167(k) actually was proposed by the Treasury--a fact that shows the ambivalence of the major institutions involved in the tax expenditure debate PATHWAYS, supra note 9, at 241.

77. See MCCOY, supra note 22, at 71.
78. INT. REV. CODE of 1954 Sec.1250(a)(1)(C)(1969)(amended 1976). The section applied to Section 221(d)(2) and Section 236 projects. See text at notes 141-148 infra for description of these programs.
79. INT. REV. CODE of 1954 Sec.1039.
80. PATHWAYS, supra note 9, at 266.
81. Act of Oct. 4, 1976, Pub. L. 94-455, 90 Stat. 1525.
82. INT. REV. CODE of 1954 Sec.1250(a)(1).
83. INT. REV. CODE of 1954 Sec.189.
84. INT. REV. CODE of 1954 Sec.1250(a)(1)(B). The excess over straight-line will be recaptured if the property is sold during the first 100 months. Thereafter the amount of recapture is gradually phased out.
85. INT. REV. CODE of 1954 Sec.189(b).
86. INT. REV. CODE of 1954 Sec.167(k)(1976).
87. INT. REV. CODE of 1954 Sec.167(k)(1).
88. SCHAPIRO, TAX SHELTERS AFTER TAX REFORM 113 (1977).
89. The Treasury in 1977 published proposed regulations that would have disallowed limited partners from taking as personal deductions (to "shelter" their personal income) those business deductions incurred by the partnership. This would have eliminated the legal basis for the economic relationship underlying all syndications.
90. The episode is set out in Simon Vetoes New Curbs on Tax Shelters, Washington Post, January 6, 1977 at 1.
91. The incentives are in INT. REV. CODE of 1954 Sec.191, which allows for a 5-year write-off of rehabilitation expenditures and INT. REV. CODE of 1954 Sec.167(o), which allows for accelerated depreciation of a rehabilitated historic property.
92. The disincentives are in INT. REV. CODE of 1954 Sec. 167(n), which disallows other than straightline depreciation if an historic structure is changed other than via a rehabilitation plan certified by the Department of

the Interior; and INT. REV. CODE of 1954 Sec. 280B, which disallows any depreciation of demolition costs when a historic structure is demolished.

93. Note that Surrey defines tax expenditure reform to include budget reform.
94. Fed. Legis. Process, supra note 45, at 26-27.
95. H. Minor, Policy Analysis and the Congress, Chapter 3 (1973) (unpublished Ph.D. Thesis at Massachusetts Institute of Technology); B.C.L. REV. 1976, supra note 43, at 680-682.
96. Pub. L. 93-344 Sections 101(c), 102(a).
97. See text at notes 29-32 infra.
98. CBO Study, supra note 3, at 51.
99. Id.
100. Id., at 55.
101. Id., at 56.
102. The two other criteria utilized in the CBO study are "incentives for good management and maintenance," and "ease of administration." See CBO study, supra note 3, at xiv. These are stray expenditure goals which the study considers important to consider in restructuring low-income housing programs. Why these are considered more important than other expenditure goals, e.g. horizontal equity, consumer sovereignty, location of projects built, is not discussed by the CBO.
103. See e.g. PATHWAYS, supra note 9, at 33.
104. This contrast is well illustrated by the treatment of tax shelters in representative sources. In Halfway to Tax Reform, a 1970 tax reform production, the chapter on "Windfalls in Real Estate" concentrates solely on the need to abolish tax shelter "loopholes." See RUSKAY, supra note 9, at 166-178. Surrey did address the need to change tax shelters benefiting low-income housing rather than simply abolishing them, in Pathways to Tax Reform in 1973. His analysis of the issue, however, was limited to a few sentences, and his only suggestion was to transfer the money spent on tax shelters to HUD's budget to be given out as a direct subsidy. He gave no details as to how the new program would work. See PATHWAYS, supra note 9, at 245.



105. Id., at 31. In grouping Surrey with the tax reformers during the late 1960's, I do not mean that his approach is identical to theirs. He at times explicitly distinguishes himself from them, see e.g. PATHWAYS, supra note 9, at 236: "Tax reformers have thought only about eliminating or cutting back (on homeowner deductions) without providing a substitute. Given Congressional attitudes towards homeownership, the latter course does not seem likely." Moreover, Surrey (in contrast to the tax reformers) clearly sees the program-design implications of his tax expenditure analysis. Yet especially during the late 1960's, he seemed to pay lip service to the wide implications of tax expenditure analysis while on most issues adopting a homeowner tax reform outlook. Examples are given in the text.
106. R. SLITOR, THE FEDERAL INCOME TAX IN RELATION TO HOUSING 5 (1968).
107. AARON, supra note 23, at 53-73.
108. NATIONAL HOUSING POLICY REVIEW (NHPR), U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, HOUSING IN THE SEVENTIES--WORKING PAPERS 895-999 (1973) (hereinafter cited as NHPR).
109. See generally, R. Slitor, Rationale of the Present Benefits for Homeowners, at 42-45, and R. Kuehn, Analysis of Existing and Proposed Tax Regulations Related to Real Estate Development in Investment, at 903-904; in NHPR supra note 108:

There should be no question that our existing tax regulations related to real estate development contain certain inequities... However, that said, it also has to be realized that...real estate development and housing development in particular is (sic) not strictly an economic, self-supporting activity, but depends in part on external forms of assistance. The Treasury Department's (i.e. the tax reformers') action to circumscribe effective tax subsidies for production cannot be unilateral, but must be balanced by compensatory mechanisms...

at 904.
110. See e.g., Memo from Charles Haar, Professor of Harvard Law School, to Stuart Eisenstadt, Domestic Policy Advisor to President Jimmy Carter (April, 1979).
111. See e.g., AARON, supra note 23, at 159-173; conversations with Arthur Solomon, Professor at M.I.T. in Cambridge MA (Spring term, 1979).

112. U.S. OFFICE OF MANAGEMENT AND BUDGET, THE BUDGET OF THE UNITED STATES GOVERNMENT--FISCAL YEAR 1981, 193 (1980) (hereinafter cited as BUDGET). This figure includes all funds spent for excess depreciation for rental housing, i.e. it includes tax shelter benefits spent for luxury apartments as well as for lower-income, government subsidized housing. It therefore overstates the funds channeled to lower-income housing. It is used as a very rough approximation of the cost of the tax shelter for lower-income housing, although of course the cost of the shelter should be increased by the cost of tax expenditures for construction period taxes and interest (and decreased by the amount of depreciation recaptured).
113. Id., at 192-193.
114. This discussion does not address the CBO study's treatment of tax shelters that benefit non-lower-income rental housing (i.e. luxury apartments) and commercial buildings. Tax reformers traditionally have agreed with housing policy reformers that such tax shelters should simply be eliminated.
115. CBO study, supra note 3, at xiii.
116. Id., at 107-108.
117. The CBO study does not endorse any alternative explicitly. I infer its favorable rating of the proposed builders' credit from the fact that it lists that alternative first and ranks it most favorably in terms of the criteria established.
118. See CBO study, supra note 3, at 67-72.
119. In an attempt to avoid chaos in the very complex task of trying to enumerate housing subsidies, I have not discussed any of the findings made available from the Farmers' Home Administration or from Community Development Block Grants; Section 202 I only refer to briefly in the footnotes.
120. I adopt HUD's term "lower-income," ludicrously vague though it is, to refer to Section 8, Section 235 and Section 236 because the programs benefit considerable numbers of moderate- and middle- as well as low-income people. See text at notes 176-178 infra.
121. A second direct subsidy, Section 202 (12 U.S.C. Sec.1701[q])

is available for housing for the elderly and normally is combined with Section 8 funds. See SENATE BUDGET COMMITTEE REPORT, supra note 24, at 258-259.

122. 42 U.S.C. Sec.1437(f). Unless otherwise indicated, references to "Section 8" discuss Section 8 New Construction/Substantial Rehabilitation, not Section 8 Existing Housing. For a description of Section 8 New Construction/Substantial Rehabilitation, see SENATE BUDGET COMMITTEE REPORT, supra note 24, at 257.
123. 42 U.S.C. Sec.1437(h).
124. In the case of a substantially rehabilitated project, the physical building is in existence, but its value is low, so that if it was sold at a foreclosure sale the proceeds would not cover the loan. It is therefore not suitable collateral to secure the mortgage.
125. Tax-exempt bonds can attract customers at lower interest rates than can conventional bonds because the after-tax yield on a tax-exempt bond is higher than the after-tax yield on an equivalent taxable bond.
126. This and the other credit programs mentioned here are more fully discussed in Section III.
127. GNMA and other secondary mortgage market entities (FNMA and FHLMC) make mortgage money more readily available in times of shortage by providing lenders assurances that GNMA will "buy" any loans they originate. Once GNMA has "bought" the loan, it pays the lender back the principal amount of the loan--thereby enabling the lender to originate another loan with the same "money." (In other words, GNMA speeds up the velocity of mortgage money, in effect raising supply.) For a clear exposition of housing financing, see generally R. STARR, HOUSING AND THE MONEY MARKET (1975) (hereinafter cited as STARR).
128. GNMA then either resells these mortgages at market rate or keeps them in its portfolio.
129. I am grateful for this example to Elliot Surkin, Esq., of Hill & Barlow.
130. The bond proceeds can be used for financing only after the building is built because it would be impossible--or at best extremely expensive--to sell unsecured bonds.
131. I am assuming for simplicity that the developer could borrow the full amount.

132. Or, in the case of tax shelters, to focus on one set of tax expenditures at a time.
133. CBO study, supra note 3, at 41. This figure includes expenditures for public housing authority bonds (\$400 million) and state housing agency bonds (\$200 million).
134. Id., at 38.
135. An example of how complex it would be to calculate the cost per unit under Section 8, see generally J.R. PRESCOTT, ECONOMIC ASPECTS OF PUBLIC HOUSING (1974). Prescott does such calculations for public housing, which has a much simpler financing structure than does Section 8.
136. The idea of "passive intervention" is introduced in P. Starr and G. Esping-Anderson, Passive Intervention, 7 WORKING PAPERS 15 (1979) (hereinafter cited as Passive Intervention).
137. See text at note 11, supra.
138. See e.g., C. Bauer, The Dreary Deadlock of Public Housing, 106 ARCHITECTURAL FORUM 140 (1959).
139. See e.g., HAAR, supra note 53, at 56 passim; Passive Intervention, supra note 136, at 18.
140. The major passive intervention adaptations of public housing were the turnkey program, in which the local housing authority (LHA) had a private developer build buildings which the LHA then managed, and Section 23 Leased Housing, in which the LHA leased privately owned units for its tenants. Both are described at AARON, supra note 23, at 118-119.
141. The rent supplement program is codified at 12 U.S.C. Sec.1701(s).
142. For a good description of the basics of Sec. 221(d)(3), see KRASNOWIESKI, supra note 74, at 260-263. It is codified at 12 U.S.C. Sec.1715(1). See FRIEDMAN, GOVERNMENT AND SLUM HOUSING 91 (1968) (hereinafter cited as FRIEDMAN) for a description of the early history of the rent supplement program. The market actually ranged from 5.76% (for new houses in 1965) to 6.90% (for existing housing in 1968). 6% is used as an average figure. U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 1973 HUD STATISTICAL YEARBOOK 345 (Table 378) (hereinafter cited as (Year) HUD YEARBOOK).

143. See e.g., M. Semer, V. Zimmerman, A Foard & J. Frantz, A Review of Federal Subsidized Housing Programs, in NHPR, supra note 108, at 121 (1973) (hereinafter cited as Review of Housing Programs): "...the hubbub which resulted from the rent supplement proposal can only be described as astonishing."
144. AARON, supra note 23, at 131.
145. See id., at 136-140, for a general description of Section 235 and Section 236. Section 235 is codified at 12 U.S.C. 1707(z): Section 236 at 12 U.S.C. 1701(z)(1).
146. Id., at 136. The market, 6.5% in 1968, rose to 8.5% by 1970.
147. Section 235 was shut down (and was not re-opened until it had been substantially reformulated) in 1970 because of scandals associated with it. See J. PYNOOS, R. SCHAFER & C. HARTMAN, HOUSING URBAN AMERICA 470 (1973) (hereinafter cited as PYNOOS).
148. Act of Aug. 1, 1968, Pub. L. 90-448, 82 Stat. 476 (codified at 42 U.S.C. Sec.3931 et seq.).
149. INT. REV. CODE of 1954 Sec.167(k).
150. Oversight of HUD Programs: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 91st Congress, 1st Sess. 259 (1974) (statement of Secty. of HUD Lynn).
151. See Review of Housing Programs, supra note 143, at 127-129 passim.
152. Section 8 in theory is a housing allowance. See discussion at notes 169-181 infra.
153. Throughout this discussion, I have lumped new construction with substantially rehabilitated housing, since the costs of substantial rehabilitation are close to those of new building.
154. The fact that Section 8 normally offered more subsidy per unit than did Section 236 ties back to the fact that Section 8 is a deeper subsidy, tied to the income of the tenant rather than to the unit rent (set at debt service plus operating expenses plus property tax plus allowable profit). The fact that 1) the gap between 25% of tenant income and the market rent of a Section 8 project has from the beginning of Section 8 been greater

than 2) the gap between the rent a normal Section 236 tenant could pay and the unit rent (as defined above), becomes evident in hearings held in Boston in 1977 on defaults of Section 236 and Section 221(d)(3) projects. See particularly, Memorandum from Rolf Goetze and Bonnie Heudorfer to Bob Walsh (Feb. 14, 1977) in Problems with Multifamily Subsidized Housing in Boston: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 95th Congress, 1st Sess. (Apr. 18, 1977) 82-88, showing how Section 8 funds were used to fill the "rent gap" between what tenants could afford to pay (defined by Section 8 as 20% of their incomes) and the unit rent (defined above).

155. See e.g., E. Goldston, BURP and Make Money, in PYNOOS, supra note 147, at 493.
156. See text at notes 120-132 supra.
157. See text at notes 128-130, supra.
158. Review of Housing Programs, supra note 143, at 140.
159. Id., at 140-141.
160. See SENATE BUDGET COMMITTEE REPORT, supra note 24, at 257-258.
161. See 1977 HUD YEARBOOK, supra note 142, at 378 (Table 35).
162. See footnote 166 infra.
163. See text at notes 263-269, infra.
164. See Review of Housing Programs, supra note 143, at 121 (Table 25).
165. This is the estimate of the subsidy per unit used by Secty. of HUD James Lynn in the hearings defending the Nixon moratorium on housing programs. Lynn's actual figure was \$2500-3000/unit. See Oversight on Housing and Urban Development Programs, Part I: Hearings Before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing and Urban Affairs, 93rd Congress, 1st Sess. 259 (1973).
166. Distressed HUD Subsidized Multifamily Housing Projects: Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 95th Congress, 1st Sess. 1 (Oct. 14 and 17, 1977) (opening statement by Senator Proxmire).

167. Dept. of Housing and Urban Development--Independent Agencies Appropriations for 1978: Hearings Before the Subcommittee of Commerce of the House Appropriations Committee, 95th Congress, 1st Sess. 37 (1977) (statement of Grace Milgram). The subsidy calculations presented are of course only examples of a number of calculations of the amount of subsidies per unit that have been made over the years. A comprehensive evaluation of all such calculations would be a study in itself. In general, such calculations have been used for two reasons: 1) to show that a given passive intervention program is cheaper than public housing, or 2) to show that all new construction programs are more expensive than programs that utilize existing housing.
168. Robert Kuttner, who was a member of the staff of the House Committee on Banking, Currency and Housing at the time the CBO study was commissioned (by that committee among others) indicated that it was not the intention of the Committee to assume the validity of the passive intervention approach.
169. A third alternative--that of returning to an active intervention production subsidy approach such as public housing--normally is not taken seriously in housing policy circles because public housing is considered such an unpopular program.
170. See text at notes 12-28 supra.
171. See text at notes 37-67 supra.
172. See note 45 supra.
173. If a taxpayer pays no tax, a credit against his tax liability does not raise his after-tax income (unless the credit is refundable, which tax credits normally are not). (See note 174 infra for a definition of a refundable credit.)
174. See e.g., B.C.L. REV. 1979, supra note 43, at 266-271. A refundable credit would provide for a direct subsidy to any taxpayer who does not have enough tax liability to offset the full amount of a tax credit.
175. See e.g., A. SOLOMON, HOUSING THE URBAN POOR 78-88 (1974).
176. CONGRESSIONAL BUDGET OFFICE, FEDERAL HOUSING POLICY: CURRENT PROGRAMS AND RECURRING ISSUES 28 (1977).

177. Id. Two production subsidies have served people as poor as have programs utilizing existing housing: rent supplements (average income \$3,544) and public housing (\$3,506). See note 169 and text at notes 140-144 supra.
178. B. FRIEDEN & A.R. WALTER, WHAT HAVE WE LEARNED FROM THE HOUSING ALLOWANCE EXPERIMENT? (Working Paper #62-- Joint Center for Urban Studies) 14 (1980).
179. See e.g., R. Starr, Which of the Poor Shall Live in Public Housing? 23 THE PUBLIC INTEREST 116; R. Scobie, "Problem Families" and Public Housing, 31 THE PUBLIC INTEREST 126 (1973); R. Starr, A Reply, 31 THE PUBLIC INTEREST 130 (1973).
180. Submarket analysis was introduced by William Grigsby in 1967. W. GRIGSBY, HOUSING MARKETS AND PUBLIC POLICY (1967). For a more recent example, see D. BIRCH, AMERICA'S HOUSING NEEDS 1970-1980 (1973).
181. See C.L. BARNETT, EXPECTED AND ACTUAL EFFECTS OF HOUSING ALLOWANCES ON HOUSING PRICES (1979).
182. CBO study, supra note 3, at 107.
183. Interview with Stanley Surrey, Professor at the Harvard Law School (Oct. 22, 1979). See also PATHWAYS, supra note 9, at 236.
184. See note 6 supra.
185. CBO study, supra note 3, at 39.
186. Id., at 38.
187. See 123 CONG. REC. 511, 40B (daily ed. July 1, 1977) (statement of Senator Kennedy).
188. See generally B.C.L.R. 1979, supra note 43; P. McDaniel, Evaluation of Tax Expenditures, 21 TAX NOTES 619 (1979); P. McDaniel, Institutional Procedures for Congressional Review of Tax Expenditures, 22 TAX NOTES 659 (1979).
189. A tax credit is less regressive than a deduction because the credit is not "worth more" the higher the taxpayer's income. See note 45 supra.
190. In 1977, 77% of Americans with incomes under \$5000 were renters. See BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE and U.S. DEPT. OF HUD, ANNUAL HOUSING SURVEY--PART A, 10 (1979).



191. Since 1977, the name of the traditional standard deduction has been changed to "zero bracket amount." For clarity I use the old, more familiar terminology.
192. I am referring here to the FHA and VA programs. Tax benefits were not thought of as housing policies until the late 1960's. See text at notes 29-32 supra.
193. See FRIEDMAN, supra note 142, at 93-95, and HAAR, supra at note 53, at 187 passim. Haar views the FHA as a "taker-of-all-comers"; Friedman shows that most of those comers have been middle class.
194. V. Bach, Chance to Own 36 (1977) (unpublished thesis at the Massachusetts Institute of Technology) (hereinafter Bach).
195. HAAR, supra note 53, at 193.
196. Id., at 34.
197. Id.
198. See FRIEDMAN, supra note 142, at 93-95.
199. Quoted in Bach, supra note 194, at 3.
200. AARON, supra note 23, at 77.
201. For example, in 1978 the maximum FHA mortgage was \$60,000. See SENATE BUDGET COMMITTEE REPORT supra note 24, at 249. The average, however, was much lower: \$34,000 in 1977. 1977 HUD YEARBOOK, supra note 142, at 128.
202. For an explanation of how subsidies can arise even in an actuarially balanced program such as the FHA, see text at note 264 infra.
203. See SENATE BUDGET COMMITTEE REPORT, supra note 24, at 249.
204. An explanation of how very large subsidies were channeled to veterans through VA loan guarantees appears in HAAR, supra note 53 at 90-101.
205. The assumption is that virtually all taxpayers who itemize a) are homeowners, and b) take homeowners' deductions. The assumption probably is fairly accurate for lower-income itemizers, since traditionally lower-income taxpayers choose to itemize in order to take the homeowners' deductions. The assumption that higher-income taxpayers who choose to itemize take homeowners' deductions probably is valid for a different reason: the percentage of homeownership traditionally has been very high among high-income taxpayers.

206. INTERNAL REVENUE SERVICE, U.S. DEPT. TREASURY, INDIVIDUAL INCOME TAX RETURNS 206 (1973).
207. Id., at 74, 85.
208. Tax reformers wanted to encourage people to take the standard deduction rather than itemizing because they considered itemized deductions a source of inequity in the distribution of the tax burden, 1) since deductions are "worth more" the higher the taxpayer's income, and 2) since most deductions are taken only (or largely) by higher-income people.
209. I include condominiums in this discussion of single-family houses. The operative distinction is between owner-occupied and rental units.
210. Passive Intervention, supra note 136, at 17. But see, 1977 HUD YEARBOOK, supra note 142, at 348, which notes that 55% of Americans could afford the median-priced new home in 1970 whereas only 41% could in 1975. Since housing prices rose very sharply between 1975-1977, it is possible the two sets of figures do not disagree.
211. See L. GREBLER & F. MITTELBACH, THE INFLATION OF HOUSING PRICES 5, 95 (1979) (hereinafter cited as GREBLER).
212. Id., at 86.
213. A homebuyer's rate of return is raised because the stream of tax benefits flowing to him in effect lowers his after-tax investment in the house.
214. Rounded figures have been chosen for purposes of illustration: the monthly payment figures are not based on a consistent assumption about interest rates.
215. See O. OLDMAN & F. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE, 1979 Supp. 3-79.
216. See New York Times, House Committee Rebuffs Two Reforms in Carter Tax Bill, Apr. 18, 1978, at 1, col.2.
217. For Mills' first public use of the term "back door spending," see 113 CONG. REC 36, 405 (1967). In that speech, Mills uses "back door spending" to refer to tax credits. I introduce the term "backdoor expenditures" to refer to credit subsidies and uncontrollable direct subsidies as well as tax expenditures. See text infra.
218. U.S. PRESIDENT'S COMMISSION ON BUDGET CONCEPTS, REPORT (1967).

219. See BUDGET, supra note 112, at 17-21; and OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS: BUDGET OF THE U.S. GOVERNMENT--FY 1981--SPECIAL ANALYSIS E, 141-206 (1980) (hereinafter cited as SPECIAL ANALYSIS).
220. This reference to major housing programs for the nonpoor excludes homeowner deductions. It refers to the two major loan guarantee programs (FHA and VA) and the secondary mortgage market entities (FNMA and FHLMC). See text at notes 249-251 infra.
221. I am omitting any discussion of Federal Home Loan Bank Board advances to savings and loan banks.
222. For a good description of the basic workings of the secondary mortgage market, see STARR, supra note 127, at 167-235.
223. In a default situation where the homeowner has a federal loan guarantee (FA or VA), 1) the government pays back the bank that originally gave the loan, 2) in the meantime, the government forecloses on the house and tries to resell it. If the house is resold for at least the amount of the defaulted homeowner's mortgage, then the government loses no money on the transaction. For a description of FHA, see AARON, supra note 23, at 77-80; for a description of VA, see id., at 80.
224. For a description of GNMA mortgage-backed securities, see M. Semer, J. Zimmerman, A. Foard and J. Frantz, Evolution of Federal Legislature Policy in Housing: Housing Credits, in NHPR, supra note 108, at 34 (1973) (hereinafter cited as Evolution of Housing Credits).
225. Federal Loan Guarantees: Hearings Before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, 95th Congress, 1st Sess. 158 (Mar. 29, 30, 1977) (hereinafter cited as 1977 Hearings). (The two major FHA programs referred to are Section 203 and Title I.)
226. Id., at 61. All figures are 1977 estimates of how much contingent liability would be outstanding in 1979.
227. See 1973 HUD YEARBOOK, supra note 143, at 346; 1977 HUD YEARBOOK, supra note 143, at 343 (Table 6).
228. Surrey directed the Treasury to draw up the first "tax expenditure budget" in 1968. See B.C.L. REV. 1976, supra note 43, at 681.
229. 1977 Hearings, supra note 225, at 112.

- 230. Id.
- 231. Id.; Loan Guarantees and Off-Budget Financing: Hearings Before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, 94th Congress, 2nd Sess. (Nov. 10, 1976) (hereinafter cited as 1976 Hearings).
- 232. 1977 Hearings, supra note 225, at 4 (statement of Elmer Staats, Comptroller General of the U.S.). The statement noted that direct loans as well as appropriated funds received a high level of scrutiny, because direct loans (unlike loan guarantees) were included in the budget prior to 1981.
- 233. Id., supra note 225, at 112.
- 234. SPECIAL ANALYSIS, supra note 219, at 145.
- 235. BUDGET, supra note 112, at 17.
- 236. See e.g., SENATE BUDGET COMMITTEE REPORT, supra note 24 at 248, for an example of the prior ad hoc credit accounting.
- 237. SPECIAL ANALYSIS, supra note 219, at 194-195.
- 238. See BUDGET, supra note 112, at Parts 2, 5, and 6 passim; SPECIAL ANALYSIS, supra note 219, at 141-205; OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES-- APPENDIX 505-510 passim (1980).
- 239. See SPECIAL ANALYSIS, supra note 219, at 198-201. Credit is also to be controlled by authorizations.
- 240. See BUDGET, supra note 112, at 19; SPECIAL ANALYSIS, supra note 219, at 199-201.
- 241. CONGRESSIONAL BUDGET OFFICE, AN ANALYSIS OF THE PRESIDENT'S BUDGETARY PROPOSALS FOR FY 1981, 51 (1980).
- 242. See SPECIAL ANALYSIS, supra note 219, at 201.
- 243. Id., at 200.
- 244. Crittenden, Government Lending Shows Surge Raising Fears on Economic Impact, N.Y. Times, March 5, 1980, at 1 (Section A), 15 (Section D) (hereinafter cited as N.Y. Times).
- 245. SPECIAL ANALYSIS, supra note 219, at 200. See also BUDGET, supra note 112, at 82. Presumably the primary

legal basis of the claim that no limit can be placed on credit programs that give an entitlement is that denial of the entitlement to some while giving it to others would violate the Constitutional guarantee of equal protection. (There may also be some notion that the entitlement is a property right, so that a blanket denial would raise due process questions.) Without further research, it is not possible to say with certainty how strong these claims are.

246. It is because the low-income housing programs never have been entitlements that the problem of horizontal equity arose and persisted.
247. The decision to take FNMA off the budget (before FHLMC was founded) originally was due to technical considerations. See STARR, supra note 127, at 193. In recent years, however, considerable sentiment has built up to put off-budget agencies back on the budget. See BUDGET, supra note 112, at 326-329. FNMA and FHLMC evidently have been able to withstand pressure to be included in the budget once again.
248. 70% of outstanding loan guarantees are for FHA and VA housing (1976 figure), 1977 Hearings, supra note 225, at 120. Eliminating those programs from the credit control system, therefore, means that only about one-third of total credit transactions are included within the credit control system. See SPECIAL ANALYSIS, supra note 219, at 201.
249. See AARON, supra note 23, at 85.
250. Id., at 89.
251. In 1970 the median price of single-family homes was \$23,500 (1970 HUD YEARBOOK, supra note 142, at 312); in 1976, the median price of single family homes was \$44,200 (1977 HUD YEARBOOK, supra note 142). By the third quarter of 1979, the median price of a single family house was \$74,500. Median prices of FHA homes were substantially lower for all three periods. BUREAU OF CENSUS, U.S. DEPT. OF COMMERCE, CONSTRUCTION REPORTS: PRICE INDEX OF NEW SINGLE-FAMILY HOUSES SOLD (3rd quarter, 1979) 1.
252. See 1977 HUD YEARBOOK, supra note 142, at 47.
253. Public housing and the public assistance programs (Sect. 236, Sect. 8) both involve direct subsidies as well as tax expenditures. (In public housing the tax expenditures are for the local housing authority bonds.)

These programs also involve credit assistance, but the great bulk of credit assistance has gone to non-poor beneficiaries through FHA, VA and the secondary mortgage market entities. Homeowners' deductions, of course, are the primary tax expenditure for the non-poor.

254. See HAAR, supra note 53, at 33. Only during World War II did the FHA and VA's proportion of total housing starts fall below 30% between 1938 and 1958.
255. See GREBLER, supra note 211, at 35 (note 4).
256. See 1973 HUD YEARBOOK, supra note 142, at 346; 1977 HUD YEARBOOK, supra note 142, at 343 (Table 6).
257. See 1977 Hearings, supra note 225, at 66. Of course, these percentage figures are influenced by the facts that a) FNMA's total assets are much larger than are FHLMC's, and b) that FHLMC is still "gearing up."
258. See, STARR, supra note 127, at 193.
259. See N.Y. Times, supra note 244, at D.15.
260. Only explicit interest rate subsidies are presented. See BUDGET, supra note 112, at 194.
261. Only in a few instances have credit subsidies been calculated. See 1977 Hearings, supra note 225, at 112.
262. See AARON, supra note 23, at 98.
263. 1977 Hearings, supra note 225, at 9.
264. See AARON, supra note 23, at 79. For example, the impact of a severe depression on the government's liability on FHA mortgages could be acute. During the Depression of the 30's, over half the mortgages in the country were foreclosed. Evolution of Housing Credits, supra note 224, at 6.
265. Id., at 80. See also HAAR, supra note 53, at 92 et seq.
266. See 1977 Hearings, supra note 225, at 83. Since the bonds finance mortgages, these in effect are mortgage guarantees.
267. See footnote 166 supra.
268. An investor who leaves his money in a housing project longer than the minimum period required a) to gain all the tax benefits flowing from the project while b)

minimizing recapture, reduces his effective rate of return because his investment will not earn any substantial amount after that period but his money still will be tied up, whereas he could reinvest that money in another context (and earn more money) if he sold his interest in the housing project.

269. INT. REV. CODE of 1954 Sec.1250(c)(10).

270. See 1977 Hearings, supra note 225, at 117 (statement of David Lilly, member of the Board of Governors of the Federal Reserve).

271. See FRIEDMAN, supra note 142, at 107.

272. Id., at 108.

273. Tenants in Sect. 235, 236 and 8 projects pay between one-fourth and one-fifth of their incomes. The programs pay the difference between the tenants' contributions and the market rents, but in no event more than the difference between market rents and what the rent level would be if the mortgage had a 1% interest rate. See AARON, supra note 23, at 136.

274. Id., at 137.

275. See CBO study, supra note 3, at 85.

276. CONGRESSIONAL BUDGET OFFICE, FEDERAL HOUSING POLICY 62 (1978).

277. Id.

278. See BUDGET, supra note 112, at 42-44, 345-350.

279. See BUDGET, supra note 112, at 346. "Housing assistance programs" are included in a list of "open-ended programs and fixed costs." Although the specific programs included are not mentioned, it would seem from the total expenditure listed (\$4.3 billion) that public housing, Section 236 and Section 8 are included, since the total cost for these 3 programs estimated in the CBO study was \$4.0 billion. See CBO study, supra note 3, at 42.

280. See BUDGET, supra note 112, at 43.

281. Id., at 44.

282. The national highway system was, of course, financed by the Highway Trust Fund; the Trust Fund in turn was financed by the proceeds of the national gasoline tax.

283. L. FRIEDMAN, A HISTORY OF AMERICAN LAW 157-158 (1973) (hereinafter cited as HISTORY OF AM. LAW).
284. Id., at 160.
285. Id.
286. Id. This law was repealed in 1842.
287. See generally, D. Kennedy, History of American Legal Thought, Chapter I passim (1975) (unpublished manuscript) (hereinafter cited as Kennedy). Similar ideas are set out in Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L. REV. 1685, 1713-1737 (1975).
288. O. & M. HANDLIN, COMMONWEALTH: MASSACHUSETTS 1774-1861, 64-92 (1947). "Torn constantly between the desire to act and unwillingness to increase expenses, the state occasionally flatly chose between saving and spending. More often it compromised and sought its ends by indirection" at 66. The Handlins list many different ways government aided economic development "without expenditure of cash" at 81. "Improvements in communications, roads and bridges... were favored beneficiaries..." at 73.
289. Of course, at this time, most of the governmental aid was not from the federal, but from state and local governments, since the federal government still was very small and relatively unimportant.
290. See generally, Kennedy, supra note 287, at Chapters II-IV passim.
291. The most famous expression of this opinion in American constitutional law, of course, was in Lochner v. New York, 198 U.S. 45 (1905).
292. When government re-entered the sphere of business in the late 1800's, it took a regulatory strategy--a much more passive approach than was taken in the pre-Civil War period. See HISTORY OF AM. LAW, supra note 283, at 385 et seq.
293. For a description on the history of municipal bonds after the Civil War, see C. FAIRMAN, HISTORY OF THE SUPREME COURT OF THE UNITED STATES, VOL. VI, RECONSTRUCTION AND REUNION 1864-1888, 918-1115 (1971).
294. For a definition of "public goods," see R. HEILBRONER & L. THUROW, THE ECONOMIC PROBLEM 227 (1978).



295. For an example of this strategy, see FRIEDMAN, supra note 142, at 14-15 passim.
296. In fact, once tax expenditures are viewed in an historical context, it becomes clear that tax expenditures are the variety of "backdoor spending" that predominated after World War II. Tax expenditures were preceded by property tax abatements and federal land grants and followed by credit activity: the predominant variety of backdoor spending has changed over time, but the spending's "backdoor" quality has persisted.
297. As noted above, Surrey and McDaniel are still focusing on translating tax expenditures, and still assume that direct subsidies are the preferable solution, but they are concentrating on "second-best" solutions such as refundable tax credits. See footnote 188 supra.
298. The CBO has made a first tentative attempt to formulate a comprehensive framework for analysis of housing policy, but the result is amorphous, in sharp contrast to the concrete reform approach offered by tax expenditure analysis. This paper suggests a much more active approach than that outlined in CONGRESSIONAL BUDGET OFFICE, A BUDGETARY FRAMEWORK FOR FEDERAL HOUSING AND RELATED COMMUNITY DEVELOPMENT POLICY (1977).
299. See text at note 80 supra.
300. I do not mean to imply that public housing is no longer an active program: it is. However, it is no longer the centerpiece of the low-income housing strategy as it was for the 30 years from 1937-1967.

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